Absa Group Limited

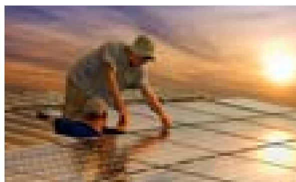
Interim risk report

for the six months ended 30 June 2012

Member of BARCLAYS

Contents

Interim risk report for the six months ended 30 June 2012.



3 – 14
Overview

3 Risk management
5 Governance
9 Summary of risks

17 – 62
Credit risk

17 Overview
19 Retail and wholesale credit risk
56 Securitisation
60 Equity investment risk

65 – 88
Market risk

65 Overview
67 Traded market risk
72 Non-traded market risk
79 Insurance risk

91 – 112
Funding risk

91 Liquidity risk
99 Capital management

115 – 120
Operational risk

115 Overview
117 Operational risk

123 – 134
Appendix

123 Glossary
131 List of abbreviations

Overview

Contents

3 – 14
Overview

3 Risk management
5 Governance
9 Summary of risks

Overview of risk management within the Group.

Introduction

Following the events of recent years, risk and its mitigation have become important priorities in the financial services industry. With the effects of the financial crisis still evident and the current unsettled sovereign debt crisis creating uncertainties in both the local and global economies, it has become increasingly important to understand and manage risks in order to create sustainable returns for shareholders. In this light, we continue to uphold and strengthen our commitment to manage risks and consequently, proactive risk management is a key pillar in our One Absa strategy. Linked to this is our board-approved Principal Risks Policy (PRP). This provides an integrated risk management framework designed to meet the challenges of the changing risk environment and to ensure that business growth plans are properly supported by effective risk management.

Responsibility for risk management resides at all levels within the Group, from the board and executive level committees down to each business unit manager and their risk specialists. This is part of instilling a strong risk culture within Absa Group Limited and its subsidiaries (the Group), where risk is everyone's business. We believe this is a core imperative of risk management. The delegation of risk management responsibilities is structured to ensure risk/reward decisions are enacted at the most appropriate level in line with business objectives, subject to robust and effective review and challenge processes. Strategic business decisions are taken in accordance with a board-approved risk appetite with executive and risk committees closely monitoring risk profiles against the appetite.

At the beginning of the reporting period we updated our PRP to identify the four principal risks we regard as our most significant potential exposures. The update to the PRP reflects a change in the way we group the risk categories and does not have any impact on the underlying risk types.

The four principal risks are:

- Credit Risk
- Market Risk (includes traded and non-traded market risk and insurance risk)
- Funding Risk (includes liquidity risk and capital management)
- Operational Risk.

In this report we focus on the above four principal risks and provide a review of these risks for the six months ended 30 June 2012.

June 2012 in review

The Group's risk management processes continued to be effective in the current reporting period, despite the tough economic environment. Our executive committees were closely involved in important risk management strategies, which focused particularly on preserving appropriate levels of capital and liquidity and effectively managing the risk portfolios. In addition, we closely monitored key areas such as market conditions, the global banking industry, Basel II.5 and Basel III requirements and anticipated demands relating to Absa's future business growth.

Two changes to our risk management processes were introduced from the beginning of the reporting period. The Group is now required to report under the new Basel II.5 framework required by the Banks' Act. In addition, the wholesale book and statutory reserve and liquid asset portfolio were moved to the Advanced Internal Ratings Based (AIRB) approach. These changes resulted in risk-weighted assets (RWAs) increasing by 4% over the reporting period, which was less than anticipated.

Key features:

- Strong capital position maintained above board-approved target ranges, incorporating buffers above minimum regulatory requirements.
- Liquidity risk management remained robust and comprehensive.
- Mortgage impairments increased significantly as indicators denoted a higher coverage needed on the mortgage legal portfolio.
- Continued steady performance for the wholesale portfolio against a backdrop of global economic uncertainty.
- Operational risk losses still within year-end budget. However, a year on year increase in the value of losses was experienced.

We maintained our strong capital adequacy position, placing us in a healthy position to deal with the implementation of Basel III requirements. Capital levels remained above target ranges for both the Group and the Bank, with Core Tier 1 capital levels improving by 20 and 40 basis points (bps) respectively. RWA optimisation remains a key focus area as it lowers the potential need to raise additional capital that may be required in the future under Basel III regulations. While our capital levels are strong, uncertainties still exist regarding the application of Basel III and the Group is participating in ongoing discussions with the regulator concerning the local application and discretionary limits of Basel III.

June 2012 in review *(continued)*

We continued to focus on liquidity risk management and to strengthen our liquidity position ahead of the implementation of Basel III in order to achieve compliance within the required timeframes. The Basel III liquidity requirements remain challenging for the Group and other South African banks in spite of the work done in recent years to further strengthen the liquidity position. We will continue to engage with the South African Reserve Bank (SARB) to ensure an appropriate implementation of the Basel III liquidity framework in South Africa.

Mortgage impairments increased significantly in the reporting period due to higher coverage being required on the legal portfolio as property prices and distressed customers remained under pressure. The impairment charge mainly relates to mortgages granted prior to the introduction of tighter lending policies. We prudently raised additional impairments and the coverage now held should help negate future deterioration in recovery rates. In addition, we improved our collections processes and systems.

We continued to effectively maintain our structural hedging programme during the reporting period, which contributed positively to the net interest margin and cash flow hedging reserve, against a backdrop of historically low interest rates.

Further reviews of the risks we manage are described in the tables following this introduction.

Looking ahead

While the challenges and uncertainties in the global economy continued, our commitment to sound risk management proved effective, as reflected in our strong capital and liquidity positions. We are working to maintain a strong level and high quality and optimal mix of capital, while continuing to generate sufficient capital to support economically profitable growth opportunities. We will also further strengthen our liquidity risk position ahead of Basel lll. The Group is well positioned for future growth and we will continue to monitor the economic and regulatory environments and enhance our risk management processes while exploiting value-adding opportunities.

Risk disclosure approach

Risk disclosures contained in this interim report relate to Basel Pillar 3 requirements and are unaudited.

Regulatory and statutory accounting treatment may differ for certain entities. Where a different treatment is applied, the following approach is followed.

Entity	Statutory accounting treatment	Basel II.5 regulatory treatment
Subsidiaries engaged in insurance activities.	Consolidated	Excluded from the calculation of the Group's capital adequacy ratio.
Associates, joint ventures and participation in businesses which are financial in nature.	Equity-accounted	Deducted from qualifying capital or proportionately consolidated.
Associates, joint ventures and participation in businesses which are not financial in nature.	Equity-accounted	Included in equity investment risk capital.

Changes to comparative numbers

This report includes the Regulator-approved changes in approach in accordance with Basel II.5 Pillar 3 requirements. In many cases the change in treatment of credit risk portfolios from the Foundation Internal Ratings Approach (FIRB) to the AIRB as well as the move of the Group's statutory reserve and liquid asset portfolio from the Standardised Approach (SA) to AIRB, caused material restatements of comparative numbers.

Basel II.5 has also driven increased reporting requirements for which comparatives cannot always be provided, especially in terms of more granular data disclosures.

Furthermore, the Group's corporate customers and products were transferred from Business Markets (previously known as Absa Business Bank) to Corporate, Investment Banking and Wealth (CIBW) (previously known as Absa Capital) for which comparatives have been restated.

The Group's approach to risk management

We employ the following five-step process in terms of our risk management:

Risk management process	
Identify	➜ Understand the principal risks fundamental to achieving the Group's strategy. ➜ Establish the risk appetite. ➜ Establish and communicate the risk management framework including responsibilities, authorities and key controls.
Assess	➜ Establish the process for analysing business-level risks. ➜ Agree and implement measurement and reporting standards and methodologies.
Control	➜ Establish key control processes and practices, including limit structures, provisioning requirements and reporting standards. ➜ Monitor controls and adherence to risk direction and limits. ➜ Provide early warning of control or appetite breaches. ➜ Ensure that risk management practices and conditions are appropriate for the business environment.
Report	➜ Interpret and report on risk exposures, concentrations and risk-taking outcomes. ➜ Interpret and report on sensitivities and key risk indicators. ➜ Communicate with external parties.
Manage/challenge	➜ Review and challenge all aspects of the Group's risk profile. ➜ Assess new risk-return opportunities. ➜ Advise on ways to optimise the Group's risk profile. ➜ Review and challenge risk management practices.

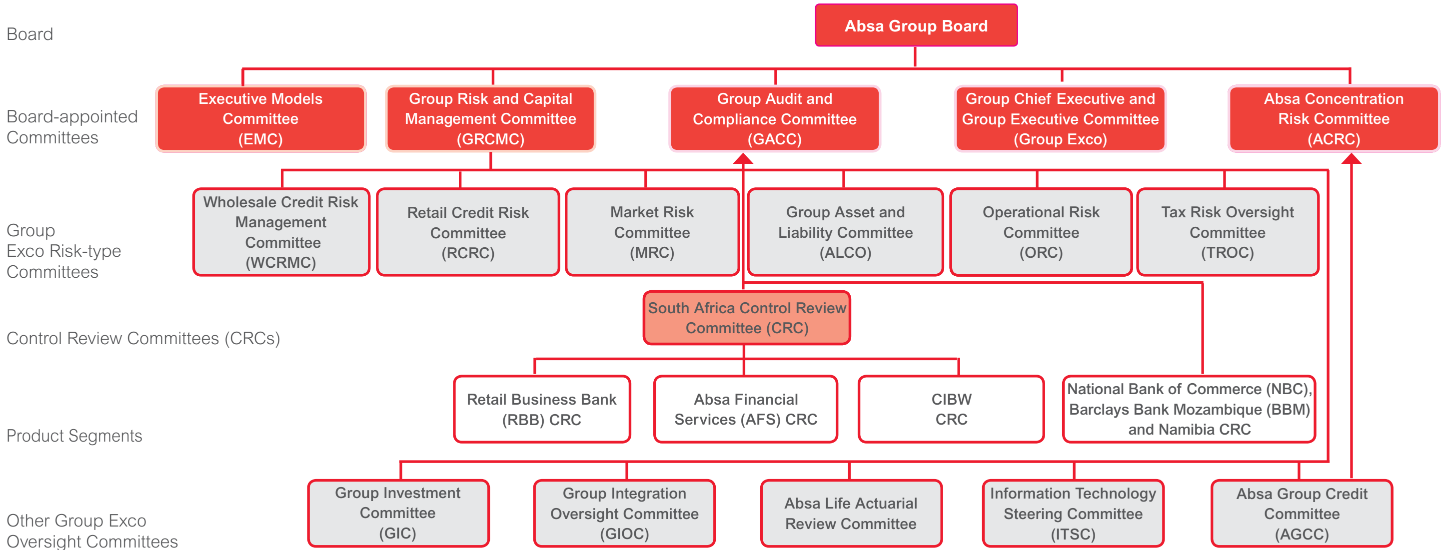
Risk oversight

Oversight of overall Group risk resides primarily with two board committees, the Group Risk and Capital Management Committee (GRCMC) and also the Group Audit and Compliance Committee (GACC). A combined assurance model, owned and managed by Group Risk, covers each principal risk and business area. The aim is to provide a co-ordinated approach to all assurance activities enabling the board and management to assess whether the significant risks facing the Group are adequately covered and to maximise the value of these activities.

The Group Chief Executive (GCE) grants authority and responsibility to the Chief Risk Officer (CRO) to ensure the principal risks are properly managed under appropriate control frameworks, and to advise on risk appetite and the Group's risk profile.

Governance

Absa's risk governance structure



The GRCMC

The GRCMC assists the board in fulfilling its responsibilities in managing risk and complying with the relevant requirements of the Banks' Act. The GRCMC determines and recommends the Group's risk appetite to the board and then reviews and monitors the Group's risk profile against the risk appetite. The GRCMC also approves control frameworks for various principal risks and assists in determining capital and liquidity target ranges and monitoring the Group's capital and liquidity levels.

The GRCMC meets on a quarterly basis.

GRCMC meetings during the reporting period were also attended by the GCE, Deputy Group Chief Executive, Group Financial Director, CRO and Group Treasurer. Internal and external auditors also attended the meetings in accordance with the Group's governance processes.

The meetings were convened under the mandate contained in its terms of reference and in accordance with applicable regulations. The GRCMC was provided with required representations and information by management at each meeting, which enabled the committee to properly review and monitor the various risks and, in so doing, effectively comply with its mandate. Adequate training is conducted annually to ensure members effectively discharge their duties.

The Chairman of the GRCMC attended all meetings of the GACC, met with the CRO and executive management on a regular basis and provided feedback to the board after each committee meeting.

Core activities of the GRCMC

The GRCMC's core activities and key decisions include:

- recommending the Group's risk appetite to the board for approval and monitoring the actual risk against the board-approved appetite;
- assisting the board in executing its duties with respect to risk and capital management as required by the Banks' Act;
- monitoring the Group's emerging risk profiles and reporting its findings to the board;
- monitoring the level of available capital, both current and projected, and reporting to the board on the adequacy of available capital relative to the emerging risk profile of the Group;
- reviewing the adequacy and effectiveness of the PRP, the completeness of principal risks coverage and the ongoing effectiveness of the framework as implemented by the Group;
- assessing the Group's risk management approach and practices in light of the global financial crisis;
- liaising with the GACC to ensure appropriate oversight of key controls and, in turn, considering and acting on concerns raised by the GACC;
- oversight of the risk governance structures and oversight measures for information technology;

The GRCMC *(continued)*

Core activities of the GRCMC *(continued)*

- ensuring the appropriate disclosure by the Group of its risk and capital management status and activities; and
- setting the Group's liquidity risk appetite and monitoring the liquidity position of the Group.

The GRCMC is satisfied that the risk management processes and systems provide comprehensive and adequate oversight over the risk exposure of the Group. The GRCMC is further satisfied that management is able to effectively respond to, and manage, the risks that arise from time to time.

The GACC

The GACC assists the board with regard to reporting financial information, selecting and properly applying accounting principles and policies, monitoring the Group's internal control systems and various compliance-related matters. Other aspects for which the GACC is responsible include business continuity and the management and governance of the Group's relationship with the external auditors, including independence.

Core risk management related activities of the GACC

The GACC performs the following core activities in terms of risk management:

- dealing with any matters referred to them by the GRCMC; and
- ensuring that a combined assurance model is applied by internal and external assurance providers and management and ensuring that the significant risks facing the Group are adequately addressed.

The Principal Risks Policy

The board-approved PRP sets out the scope of the risks facing the Group and creates clear ownership and accountability for risks. The updated policy covers the four principle risks (as discussed earlier) as well as the 22 key risks (as detailed in the table to follow).

The CRO appoints a Group Principal Risk Owner (Group PRO) for each principal risk. Within each principal risk there are individual key risks for which the CRO appoints a Group Key Risk Owner (Group KRO). Group PROs are responsible for ensuring that appropriate risk control frameworks exist for each key risk and for ensuring that the Group risk profile reports appropriately on those risks.

Group KROs are responsible for designing, recording and communicating their risk control frameworks. They further monitor the management of the key risk exposures throughout the Group in accordance with the in-framework, using the five step process to risk management as per page 5 of the report. Group exco risk-type committees meet on a regular basis to assess and monitor the key risks.

Principle risk	Key risks	Group exco risk-type committees
Credit risk	→ Retail credit risk → Wholesale credit risk	→ Retail Credit Risk Committee (RCRC) → Wholesale Credit Risk Management Committee (WCRMC)
Market risk	→ Traded risk → Interest rate risk in the banking book[1] → Pension risk[1] → Insurance risk	Market Risk Committee (MRC)

Note

[1]This is reported together with foreign exchange risk and asset management structural market risk as 'non-traded market risk'.

The Principal Risk Policy *(continued)*

Principle risk	Key risks	Group exco risk-type committees
Funding risk	➜ Liquidity risk ➜ Capital management ➜ Structural risk	Group Asset and Liability Committee (ALCO)
Operational risk	➜ External supplier risk ➜ Financial reporting risk ➜ Fraud risk ➜ Information risk ➜ Legal risk ➜ Product risk ➜ Payment process risk ➜ People risk ➜ Premises and security risk ➜ Regulatory risk ➜ Tax risk ➜ Technology risk ➜ Transaction operations risk	Operational Risk Committee (ORC) (except for tax risk, via Group Tax Committee)

The Group's risk appetite

The Group's risk appetite is defined as the level of risk the Group is willing to accept in fulfilling its business objectives. The Group's risk appetite framework is embedded within key decision-making processes and supports the implementation of the Group's strategy. The Group uses this to maximise returns without exposing it to levels of risk above its appetite. In particular, the risk appetite framework assists in protecting the Group's financial performance, improves management responsiveness and debate regarding the Group's risk profile, assists executive management in improving the control and co-ordination of risk-taking across business units (BUs) and identifies unused risk capacity in pursuit of profitable opportunities.

The risk appetite framework is developed using a formal quantitative method and is set by the board. Risk appetite outcomes are subjected to stress testing, (i.e. validated by estimating the Group's sensitivity to adverse changes in the business environment). This framework then forms the basis for setting BU targets and risk-taking limits across the Group.

The Group's risk appetite can be categorised into four broad areas namely:

- earnings volatility in comparison to targets;
- capacity to absorb unexpected losses;
- capital ratio targets; and
- capacity to grow.

Stress testing

Stress testing is embedded in the risk management of the Group and is a key focus area in strategic planning processes. Through stress testing and scenario analysis, the Group is able to assess the performance of its portfolios under potentially adverse economic conditions.

Stress tests simulate the effects on the BUs' financial position across the Group by analysing the impact on profits and the ability to maintain appropriate capital ratios and liquidity levels. Insights gained are integrated into the management process covering the medium to long-term horizon. Stress testing also forms an integral part of evaluating the Group's risk appetite for reasonableness under specifically designed scenarios. Stress tests are regularly discussed with the regulators.

Risk report summary table

Credit risk	June 2012 in review	Looking ahead

Credit risk

Definition

Loss to the Group arising from the failure of a customer or counterparty to fulfil its payment obligations.

Key performance indicators

	30 Jun 2012 %	30 Jun 2011 %	31 Dec 2011 %
Growth in loans and advances	**0,34**	(0,91)	(0,76)
Non-performing loans as a percentage of loans and advances to customers	**6,4**	7,6	6,9
Impairment losses ratio	**1,59**	1,16	1,01
Total credit impairments as a percentage of total gross loans and advances to customers	**2,51**	2,61	2,35

Strategy

- Invest in skills and experience.
- Operate sound credit granting processes.
- Monitor credit diligently.
- Use models to assist decision-making.
- Continually improve collection and recovery.

June 2012 in review

Wholesale credit risk

- European sovereign debt uncertainties continues to affect market confidence and corporate confidence remains subdued.
- Corporate credit extension increased mostly due to working capital facilities.
- Wholesale portfolio performance steady despite volatility in local equity markets.
- Value of exposures on the early warning watchlist (EWL) decreased and the loan loss rate increased marginally.
- Legal book in Business Markets (BM) contracted due to less transfers to legal, fewer write-offs and better collections.

Retail credit risk

- Mortgage impairments increased significantly as indicators denoted a higher coverage needed on the mortgage legal portfolio (refer to credit risk section for further detail).
- Overall conditions remained challenging with growth proving difficult and the total portfolio remaining static.
- Lending policies are regularly reviewed to optimise returns and early delinquencies improved across all portfolios.
- Secured portfolios remained under pressure due to process of resolving legal book, debt counselling process and subdued mortgage markets.
- Recovery in legal portfolios and properties in possession was protracted despite revisions to collection strategies/processes.
- Non-performing loans (NPLs) in the unsecured portfolio and impairments in all other portfolios performed within expectations.

Securitisation

- Reduction during the reporting period due to natural amortisation and early redemption of notes.

Equity risk in the banking book

- Selected assets successfully exited during the reporting period.

Looking ahead

Focus areas include:

Wholesale credit risk

- Monitoring portfolio composition.
- Enhancing the risk and control framework.
- Further embedding AIRB principles in business.

Retail credit risk

- Continuing to focus on value and balance sheet optimisation.
- Focusing on quality and profitability of new business written (including being selective therein).
- Rehabilitating customer arrears in step with affordability and improve collections.
- Reducing NPLs by optimising potential value when disposing of assets.

Securitisation

- Reducing level of on-statement of financial position securitisation exposures through the natural attrition and maturity of the notes held.

Equity risk in the banking book

- Balancing portfolio composition in line with risk appetite, with further selective exits as appropriate.

Summary of risks

Market risk – Traded and non-traded	June 2012 in review	Looking ahead

Market risk – Traded and non-traded

Definition

The risk that our earnings, capital or ability to meet business objectives will be adversely affected by changes in the level or volatility of market rates or prices such as interest rates, foreign exchange rates, equity prices, commodity prices and credit spreads.

Key performance indicators

	30 Jun 2012	30 Jun 2011	31 Dec 2011
Average traded market risk (DVaR) (Rm)	**19,44**	25,80	23,73
Traded market risk regulatory capital (RC) (at 8% of RWAs) (Rm)	**1 066**	788	669
Banking book AEaR for a 2% interest rate shock (% of Group net interest income)	**<5%**	<5%	<5%

Strategy

- Maintain a hedge programme encompassing non-traded interest rate risk and equity, towards greater net interest margin stability over a full interest rate cycle.
- Ensure non-traded interest rate risk is hedged with external market by a business treasury operation or Group Treasury.

June 2012 in review

Traded market risk

- Exposures were actively managed as well as trading revenue ensuring a favourable risk-adjusted return over the reporting period.
- Average traded market risk (daily value at risk (DVaR)) decreased to R19,44 million in line with a reduced risk profile.
- Tail risk and stress analyses were performed to monitor impact from market volatility and event risk.
- Regulatory approval for use of DVaR internal models approach for trading book general position risk was maintained.
- Additional stressed VaR regulatory capital requirements were implemented during the reporting period.
- Countercyclical enhancements to traded market risk economic capital framework were implemented during the reporting period.

Non-traded market risk – interest rate risk in the banking book

- Managed to low risk appetite levels. Exposure of the Group to prime-Johannesburg Interbank Agreed Rate (JIBAR) basis risk remains.
- Hedge programme for structural products and equity contributed positively to interest margin for the reporting period when South African interest rates were at a historical low.
- Cash flow hedging reserve increased as a result of favourable mark-to-market movements.

Looking ahead

Focus areas include:

Traded market risk

- Monitoring spill-over effects of Euro debt crisis and global growth into the South African economy.
- Focusing on risk-adjusted returns and efficient use of risk capital across trading desks and products (more especially in flow business with customers where RWA usage is efficient).
- Expanding product range in African markets (including fixed income, commodities and derivatives).

Non-traded market risk – interest rate risk in the banking book

- Focusing on the risk of margin compression and efficient maintenance of the structural hedge programme in line with low South African interest rates.

Market risk – Insurance	June 2012 in review	Looking ahead

Market risk – Insurance

Definition

The risk that future claims and expenses will exceed the allowance for expected claims and expenses in measuring policyholder liabilities and in product pricing.

Key performance indicators

	30 Jun 2012 %	30 Jun 2011 %	31 Dec 2011 %
Short-term loss ratio	**68,7**	68,2	67,4
Life new business margin	**8,1**	8,5	7,4
Return on shareholders' assets versus benchmark	**3,8 vs 4,1**	2,3 vs 2,6	7,3 vs 6,9

Strategy

- Ensure adequacy of reserving and rating through appropriate risk management and governance.
- Pursue profitable growth opportunities.
- Balance exposure between life and short-term insurance.

June 2012 in review

Market risk – Insurance

- Insurance risk types remained within risk appetite for the reporting period.
- Rebalancing of Absa Life offshore investment portfolios are being implemented.
- Focus on profitability management per product line maintained to ensure required level of returns.
- South African Insurance entities continue in preparation for Solvency Asset Management (SAM) legislation.
- Requirements for launch of new insurance entity, Barclays Life Zambia in August 2012, finalised.
- Hedging solution for Absa Life maturity guarantees implemented.
- Short-term ratios construed to be stable.

Looking ahead

Focus areas include:

- Developing capital model for short-term insurance environment.
- Focusing on driving product profitability to achieve targeted returns on capital allocated to individual product lines.
- Preparing for SAM legislation.
- Diversifying risk between South African and non-South African risks.
- Enhancing risk reporting and measurement to improve the monitoring of risk appetites and capital requirements across insurance businesses (particularly in respect of non-South African insurance exposures).

Summary of risks

Funding risk – Capital management	June 2012 in review	Looking ahead

Definition

Failure to maintain adequate levels of capital and/or losing our investment grade credit rating.

Key performance indicators[1]

	30 Jun 2012 %	30 Jun 2011 %	31 Dec 2011 %
Core Tier 1 capital adequacy ratio	**13,2**	12,8	13,0
Return on average risk-weighted assets (RoRWA)	**2,08**	2,23	2,35
Return on average economic capital (RoEC)	**20,8**	22,4	23,0
Cost of equity[2]	**13,5**	14,0	14,0

Strategy

- Maximise shareholder value by optimising the level and mix of capital resources.

Capital management

- Strong capital position remained above board approved target ranges with Core Tier 1 capital levels improving by 20 and 40 bps respectively for the Group and Bank.
- Successful implementation of AIRB approach on wholesale portfolio and Basel II.5 with minimal impact on Core Tier 1.
- Optimal mix of capital remained a key priority.
- Continued focus on net generation of equity and RWA optimisation.
- Industry wide discussion with SARB on pending Basel III regulatory changes continued in order to ensure clarity from a South African perspective.

Focus areas include:

- Maintaining a strong level and a high quality optimal mix of capital.
- Generating sufficient capital to support economically profitable asset growth while managing business portfolio.
- RWA optimisation.
- Optimising use of capital without jeopardising ability to comply with expected Basel III changes.
- Engaging with SARB to clarify implementation of Basel III from an African perspective (local discretionary limits still to be determined).

Notes

[1]Reported ratios include unappropriated profits.

[2]The average cost of equity is based on the Capital Asset Pricing Model (CAPM).

Summary of risks

Funding risk – Liquidity risk	June 2012 in review	Looking ahead

Funding risk – Liquidity risk

Definition

Failure to meet the Group's payment obligations when they fall due and to replace funds when they are withdrawn, the consequences of which may be the failure to meet obligations to repay depositors and to fulfil commitments to lend. It is the risk that the Group will be unable to continue operating as a going concern due to a lack of funding.

Key performance indicators

	30 Jun 2012 %	30 Jun 2011 %	31 Dec 2011 %
Long-term funding ratio	**25,6**	26,8	26,8
Loans-to-deposits ratio	**86,9**	91,0	88,4

Strategy

- Grow and diversify the funding base.
- Lengthen the Group's funding profile.
- Build surplus liquid asset holdings.
- Lower the weighted average cost of funding.

June 2012 in review

Liquidity risk

- Liquidity position remained strong as focus on increasing surplus liquid asset reserves, extending funding term and growing deposit base continued.
- Relatively slow growth in South African economy resulted in supply of liquidity remaining strong.
- Successful issuance of senior unsecured debt in March 2012 to extend funding term and diversify funding base.
- Position of reduced reliance on wholesale money market funding sources maintained.
- Cost of liquidity remained fairly stable with gradual increase in liquidity cost.
- Appetite for term funding in money markets dampened in response to asset managers rebalancing duration profiles on money market funds. However, an amendment to average duration restrictions (90 days to 120 days) in the Collective Investment Schemes Act is expected to improve this appetite.

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Looking ahead

Focus areas include:

- Improving the strong liquidity risk position ahead of Basel III.
- Ensuring full compliance with Basel III within the required timeframes.
- Review and plan for the SARB-approved liquidity coverage ratio (LCR) under Basel III.

Summary of risks

Operational risk	June 2012 in review	Looking ahead

Definition

Direct or indirect losses resulting from inadequate or failed internal processes or systems, human error or external events. Operational risk exists in the natural course of business activity.

Key performance indicators

	30 June 2012	30 June 2011	31 Dec 2011
Total number of events	↓	↓	↓
Total loss value	↑	↓	↓

Strategy

- Further embed an operational risk-aware culture throughout the Group.
- Hold a risk-sensitive RC for operational risk under the Advanced Management Approach (AMA).
- Enhance controls using automated solutions as far as possible, specifically relating to fraud and e-fraud.
- Set and monitor appropriate operational risk appetite and tolerance levels.

Operational risk

- Advanced measurement approach (AMA) approval by SARB maintained subject to regulatory capital (RC) floors.
- A year-on-year increase in value of losses experienced. However the losses are within budget.
- Continued improvements in control environment as evidenced by reduction in volume of loss events for 2012.
- No adverse risk beyond risk appetite indicated by risk and control assessments and key risk indicators.

Focus areas include:

- Continuing to minimize the extend of fraud through implementation and enhancement of fraud systems.
- Mitigating operational risks from new projects and programmes.
- Enhancing technology risk management capabilities.
- Monitoring risks on the regulatory front.

Credit Risk

Contents

17 – 62
Credit risk

17 Overview
19 Retail and wholesale credit risk
56 Securitisation
60 Equity investment risk

Approach to credit risk.

Overview

Key points to note

- Mortgage impairments increased significantly as indicators denoted a higher coverage needed on the mortgage legal portfolio.
- Enhanced scorecard development for secured lending origination strategies.
- Continued focus on rehabilitating customer arrears and improving collections processes.
- Formal SARB approval obtained for use of AIRB approach in wholesale portfolio.
- Continued steady performance of wholesale portfolio against a backdrop of global economic uncertainty.
- Enhanced governance and operational efficiencies.
- Optimising the potential value when disposing of assets.

Key performance indicators

	30 June		31 December
	2012	2011	2011
Growth in loans and advances (%)	**0,34**	(0,91)	(0,76)
Non-performing loans as a percentage of total gross loans and advances (%)	**6,4**	7,6	6,9
Impairment losses ratio	**1,59**	1,16	1,01
Total credit impairments as a percentage of total gross loans and advances (%)	**2,51**	2,61	2,35

Introduction

Credit risk is the risk of loss to the Group arising from the failure of a customer or counterparty to fulfil its payment obligations. Credit risk arises mainly from lending and related banking activities, including underwriting, dealing in traded products such as derivative contracts, and securities borrowing and lending products. It may also arise when fair values of the Group's exposure to financial instruments decline.

Credit risk is a core component of lending quality and impacts on the risk versus reward model. Credit risk has received increased focus due to the current economic conditions and subdued growth as well as increased regulatory requirements under Basel II.5.

Strategy

The Group's credit risk management objectives are to:

- maintain an appropriate credit risk structure through continued investment in skilled and experienced staff;
- operate under a sound credit-granting process, using the flexibility of industry leading systems;
- maintain an appropriate credit administration, measurement and monitoring process;
- ensure adequate and operationally effective controls over credit risk;
- optimise the use of available credit bureau data to make informed decisions and to build robust models (risk and reward);
- proactively manage credit risk through the economic cycle and ensure the desired return/economic profit is maintained;
- manage credit risk and the mitigation thereof within the risk appetite boundaries of the Group;
- measure credit risk inherent in the portfolios using models which are relevant and accurately calibrated; and
- continue to focus on enhancing the Group's collection and recovery processes.

June 2012 in review

Wholesale credit risk

The disappointing supply-side growth momentum observed in the second half of last year has continued into 2012. Headline consumer price inflation is lower than expected, largely due to subdued food price inflation. This has not been sufficient to positively sway corporate confidence, which remains flat. Although corporate credit extension has increased from 2011, this has largely been restricted to working capital facilities rather than asset backed finance, suggesting a lack of corporate appetite for long-term capital investment. This is confirmed by an increase in corporate savings to 7% of Gross Domestic Product (GDP), well above the long-term average of 4%.

Internationally, European sovereign debt fears continue to affect market confidence, particularly against a backdrop of a slowing and increasingly volatile global economy. While the Group's direct exposure to European banks is modest and largely collateralised, concerns persist about the impact of continued European volatility on international economic growth prospects. This combination of local and international uncertainty has manifested in significant volatility in local equity markets during the reporting period. This has resulted in a marginal degrading of credit quality across sectors within the wholesale portfolio. Notwithstanding this, the performance of the Group's wholesale book in 2012

June 2012 in review *(continued)*

Wholesale credit risk *(continued)*

has been reasonably steady. The value of exposures on the EWL (the Group's distressed debt list) has decreased, and the loan loss rate has increased only marginally. The legal book within Business Markets continued with its downward trend as a result of a combination of less transfers to legal, fewer write offs and an acceptable level of collections. Asset values for security purposes remained under pressure resulting in slightly higher loan loss rates.

Retail credit risk

Conditions remained challenging as signs of the expected economic recovery were less evident than at the end of last year. Growth proved difficult and the total portfolio remained static. The Group regularly reviewed its lending policies to optimise returns.

Early delinquencies continued to improve in all portfolios.

The lengthy process to resolve the legal book in the secured portfolios, exacerbated by the debt counselling process and a subdued mortgage market kept secured portfolios under pressure. Although the collections strategies and processes were revised where appropriate, recovery in the mortgage legal portfolio and properties in possession was protracted. The performance of NPLs in the unsecured portfolios is within expectations.

Mortgage impairments increased significantly in the reporting period due to higher coverage required on the mortgage legal portfolio as property prices and distressed customers remained under pressure. The impairment charge relates to mortgages granted before the introduction of tighter lending policies. Recovery rates on distressed property sales deteriorated in the challenging economic conditions, but the Group acted prudently in raising additional impairments and the coverage it now holds should help negate future deterioration in recovery rates.

The approach to customers experiencing difficulties is to keep them in their homes where possible. The credit impairments relate to mortgages on homes that belonged to customers who found themselves in financial distress and who, despite the Group's best efforts, have been unable to get back onto a sound financial footing.

The Group is confident that it understands the extent of the issues, is taking appropriate measures to address the issues and has the correct approach to lending.

Impairments in all the other portfolios performed as expected.

Securitisation

In line with the Group's strategy, Absa's securitisation portfolio reduced during the reporting period. The notes held on the statement of financial position reduced from R1,6 billion at 31 December 2011 to R800 million at 30 June 2012 due to natural amortisation and early redemption of the notes.

Equity investment risk in the banking book

Selected assets in the Group's equity investment portfolio were successfully exited during the reporting period.

Looking ahead

Wholesale credit risk

The Group will continue to focus on reducing both exposure on the EWL and to monitor the portfolio composition. The risk and control framework will be further enhanced and AIRB principles firmly embedded in the business. Coverage ratios across segments, benchmarked against the Group's peer group and counterparties exposed to the Eurozone, will also receive increased attention.

Retail credit risk

The Group will continue to focus on value and balance sheet optimisation. The aim is to increase portfolio growth through defining low risk pockets/products and improve decision-making processes by continuously assessing market conditions and understanding the impact of economic shifts on the various portfolios. The Group will therefore remain focused on the quality and profitability of new business it writes and will continue to be selective in the type of business written within the mortgage portfolios.

A key component of the 2012 strategic focus for this area is to reduce the non-performing loans, especially in the secured portfolios, by optimising potential value when disposing of assets.

Securitisation

The strategic focus for securitisation transactions is to reduce the level of on-statement of financial position securitisation exposures.

Equity investment risk

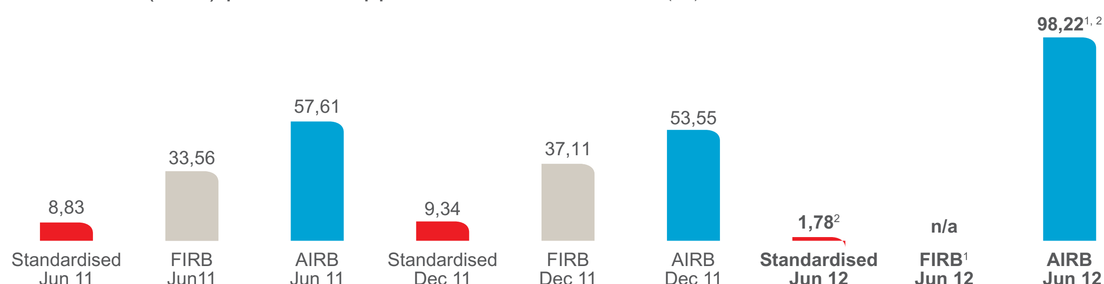
The Group will continue to focus on balancing the portfolio composition in line with the Group's risk appetite, with further selective exists, as appropriate.

Approach to credit risk

The Group applies both the standardised and internal ratings-based (IRB) approaches to various portfolios to calculate RC requirements, as illustrated in the following table:

Approaches	Standardised	AIRB[1]
Reporting of balances	➜ African operations	➜ Domestic retail portfolios ➜ Domestic corporate portfolios (including specialised lending portfolios) ➜ Public sector entities ➜ Local government ➜ Municipalities ➜ Sovereign, banks and securities firms ➜ Statutory reserve and liquid asset portfolio
Assessment applied	➜ Standard risk weight percentage as prescribed in the regulations relating to banks	➜ Automated application and behavioural scoring based on statistical models ➜ Statistical, structural and expert based models either developed internally or based on service of external vendors

Exposure at default (EAD) per Basel Approach as at June 2012 (%)



Notes

[1]The Group's wholesale portfolio moved from the FIRB to the AIRB approach with effect from 1 January 2012. This resulted in a year-on-year decrease in the FIRB portfolio.

[2]The Group's statutory reserves and liquid asset portfolio moved from the standardised to the AIRB approach with effect from 1 January 2012. This resulted in a decrease in the standardised portfolio, compared to comparative reporting periods.

Retail and wholesale credit risk

Approach to credit risk *(continued)*

RWAs and minimum required capital	30 June 2012 RWAs Rm	30 June 2012 Required capital Rm	30 June 2011 RWAs Rm	30 June 2011 Required capital Rm	31 December 2011 RWAs Rm	31 December 2011 Required capital Rm
Banks	**9 261**	**880**	5 913	562	9 925	943
Corporate exposure	**135 869**	**12 908**	132 584	12 595	148 297	14 083
Corporate	**100 591**	**9 557**	105 696	10 041	113 161	10 750
SME Corporate	**29 094**	**2 764**	22 036	2 093	27 492	2 611
Specialised lending – income producing real estate	**1 942**	**184**	1 471	140	2 986	282
Specialised lending – project finance	**4 242**	**403**	3 381	321	4 658	440
Local governments and municipalities	**1 511**	**143**	2 447	232	3 054	290
Public sector entities	**1 294**	**123**	2 368	225	2 378	226
Retail	**148 151**	**14 074**	143 220	13 606	141 331	13 432
Residential mortgages advances	**61 746**	**5 866**	58 542	5 561	58 123	5 521
Retail – other	**50 600**	**4 806**	50 355	4 784	48 754	4 631
Vehicle and asset finance[1]	**26 130**	**2 482**	n/a	n/a	n/a	n/a
Unsecured lending <= 30 000[1]	**5 687**	**540**	n/a	n/a	n/a	n/a
Unsecured lending > 30 000[1]	**18 783**	**1 784**	n/a	n/a	n/a	n/a
Retail – revolving credit	**24 588**	**2 336**	21 281	2 022	22 078	2 097
Credit cards[1]	**22 434**	**2 131**	n/a	n/a	n/a	n/a
Non-credit cards[1]	**2 154**	**205**	n/a	n/a	n/a	n/a
SME Retail	**11 217**	**1 066**	13 042	1 239	12 376	1 183
Secured lending[1]	**2 985**	**284**	n/a	n/a	n/a	n/a
Unsecured lending[1]	**8 232**	**782**	n/a	n/a	n/a	n/a
Securities firms	**553**	**53**	175	17	393	37
Securitisation[2]	**1 316**	**125**	2 571	244	1 716	163
Sovereign	**3 570**	**339**	164	16	231	22
	301 525	**28 645**	289 442	27 497	307 325	29 196
Standardised approach	**10 212**	**970**	9 409	894	10 595	1 006
Total	**311 737**	**29 615**	298 851	28 391	317 920	30 202

Standardised approach

The Group's African operations and the statutory reserve and liquid asset portfolio are subject to the standardised approach. For capital calculation purposes, these exposures are multiplied by the standard risk-weight percentages as set out in the Banks Act. Following SARB approval, the statutory reserve and liquid asset portfolio have been moved to the AIRB approach with effect from 1 January 2012.

AIRB

To assess credit risk under this approach, the Group analyses this risk into its common components of probability of default (PD), EAD and loss given default (LGD), modelled on an exposure specific basis in the case of wholesale exposures and on a portfolio level in the case of retail exposures. These risk components are then used in the calculation of a number of aggregate risk measures such as expected loss (EL), RC and economic capital (EC). Under the advanced approach, the Group can use its own measure of PD, LGD and EAD. Following SARB approval, the Group migrated its wholesale portfolio to the AIRB approach with effect from 1 January 2012.

Notes

[1]Due to the new Basel II.5 reporting requirement, the prior period's information is unavailable.

[2]Securitisation were previously reported as part of retail. This has been revised and is now separately disclosed. Granular asset class disclosure is provided in the securitisation section.

Approach to credit risk *(continued)*

AIRB *(continued)*

The assessment of credit risk relies heavily on quantitative models and tools developed internally and are supplemented by vendor solutions in a number of areas.

The Group classifies all credit models by materiality, based on a combination of measures aimed at assessing the 'value at stake' (VAS) for the Group. The VAS measure used for a specific model is determined by its relevance to the respective portfolio and the risk it is intended to assess. The pertinent measures for most credit models are EC and the amount of exposure covered by the model.

High materiality models require EMC approval. All models are monitored on an ongoing basis and validated, at least annually, by an independent validation unit within Group credit. The monitoring information and validation results are reported to and discussed at the appropriate governance forums.

Approach to credit modelling/internal ratings

The principal objective of credit risk measurement is to produce the most accurate possible quantitative assessment of credit risk to which the Group is exposed from the level of individual facilities up to the total portfolio. Integral to this is the calculation of internal ratings which are used in numerous aspects of credit risk management and in the calculation of RC and EC. The key building block parameters of this process are:

- PD;
- EAD;
- LGD; and
- maturity.

These parameters are used in a variety of applications that measure credit risk across the entire portfolio and can be calculated to represent different aspects of the credit cycle:

- PD estimates can be calculated on a through-the-cycle (TTC) basis, reflecting the predicted default frequency in an average 12-month period across the credit cycle, or on a point-in-time (PIT) basis, reflecting the predicted default frequency in the next 12 months.
- LGD and EAD estimates can be calculated as downturn measures, reflecting behaviour observed under stressed economic conditions, or as business-as-usual (BAU) measures, reflecting behaviour under actual conditions.

These parameters can be used in different combinations for a wide range of credit risk measurement and management. Internal ratings are used for the following purposes:

- Credit approval: PD models are used in the approval process in both retail and wholesale portfolios. In high-volume retail portfolios, application and behaviour scorecards are frequently used as decision-making tools. In wholesale and certain retail mortgage portfolios, PD models are used to direct applications to an appropriate credit sanctioning level.
- Credit grading: to provide a common measure of risk across the Group. Wholesale credit grading employs a 26 point scale of default probabilities.
- Risk-reward and pricing: PD, EAD and LGD metrics are used to assess the profitability of deals and portfolios and to allow for risk-adjusted pricing and strategy decisions.
- Risk appetite: measures of expected loss and the potential volatility of loss are used in the Group's risk appetite framework.
- Impairment calculation: under *(IAS 39 Financial Instruments: Recognition and Measurement)*, many of the collective impairment estimates incorporate the use of the Group's PD and LGD models, adjusted as necessary.
- Collections and recoveries: model outputs are used to identify segments of the portfolio where collection and recovery efforts should be prioritised.
- EC calculation: most EC calculations use the same PD and EAD inputs as the RC process. The process also uses the same underlying LGD model outputs as the RC calculation, but does not incorporate the same economic downturn adjustment used in RC calculations.
- Risk management information: Group Risk and the business units generate risk reports to inform senior management on issues such as the business performance, risk appetite and consumption of EC. Model outputs are used as key indicators in these reports.

Retail portfolios

Ratings assigned across each retail portfolio are based on automated application and behavioural scoring systems. The underlying rating is calculated at point of application and updated monthly thereafter and used in decisions concerning underwriting, 'pay/no pay' and assignment of accounts to risk grades used to calculate RC. The methodology and data employed in the risk estimation and the rating processes can be summarised as follows:

- Internal risk estimates of PD, LGD and EAD are grounded in historical experience which incorporate all relevant material and available data, information and methods. Both the historical observation periods and default definitions used are consistent with regulatory requirements.
- For each product, PDs are assigned at account level by calibrating the raw behavioural model scores/ratings to the observed long-run average default rate for each pool.

Retail and wholesale credit risk

Approach to credit risk *(continued)*

Retail portfolios *(continued)*

- For each product, EADs are assigned to each account based on the EAD pool to which the account has been assigned. EAD estimates incorporate all relevant data and information including account balance, accrued interest, and utilised and unutilised limits, if present.
- LGDs are estimated for each product and assigned at account level based on the LGD pool to which the account has been assigned. Calibration data on historically defaulted accounts includes observed EADs, recovery streams, cure and write-off rates. The models also make use of suitable risk drivers such as loan-to-value (LTV), which are updated monthly.

Further, all retail models were recalibrated in the reporting period with the exception of the Vehicle and Asset Finance (VAF) and credit card LGD models and all the PD models. All recalibrations except for three that are awaiting SARB approval were implemented by 1 July 2012.

To ensure the effectiveness of the validation process an independent review is performed annually. Models are approved by the Retail Credit Risk Technical Committee and the most material models require approval by the EMC.

The Absa Model Risk Policy (MRP) sets detailed standards that a model needs to meet during development and subsequent use.

Retail Markets has in the past two years redeveloped its Basel models based on international best practice standards. Methodology and documentation across its retail portfolios have been standardised resulting in improved transparency in the capital allocation process. More specifically they have developed the following:

- new bespoke scorecards, incorporating international input, which replaced the generic scorecards that had been in place since implementation of the Basel accord;
- amended PD methodology based on the variable scaler approach which is used to determine TTC PD estimates; and
- amended LGD methodologies specifically for the Group’s retail secured and unsecured portfolios.

Wholesale portfolio

The rating process relies both on internally developed PD rating models and vendor provided solutions. While the rating and credit decision-making process in the retail portfolio is largely automated, these processes in the wholesale portfolio rely on credit analyses and intuitive assessments. Information used in the calculation of customer ratings includes:

- financial statements;
- projected cash flows;
- equity price information;
- external rating agency grades; and
- behavioural scorecards.

Internal LGD estimates depend on the key drivers of recovery such as collateral value, seniority and costs involved as part of the recovery process, while the EAD models aim to replicate the expected utilisation of a customer’s facility should a default occur. Following SARB approval an EAD and LGD model for the wholesale portfolio has been implemented with effect from 1 January 2012.

PD measures based on behavioural scores and equity prices are updated monthly for credit risk management and capital calculation purposes. Other PD models which rely on more static information are updated at least quarterly in a conventional environment or as and when extraordinary circumstances warrant a review of the customer’s credit standing.

To ensure the effectiveness of the validation process an independent review is performed annually. Models are approved at the Wholesale Credit Risk Technical Committee, and the most material models require approval by the EMC.

The Absa Model Risk Policy sets detailed standards that a model must meet during development and subsequent use.

Assessment of credit risk

The assessment of credit risk relies heavily on quantitative models and tools which, to a large degree, have been developed internally and which are supplemented by vendor solutions. The following sections provide an overview of the aforesaid concepts and their use in the assessment of credit risk across the Group’s portfolios.

Probability of default (PD)

The PD measures the likelihood of a customer defaulting on its obligations within the next 12 months and is a primary component of the internal risk rating calculated for all customers. The Group uses two types of PDs, namely:

- TTC PD, which reflects the Group’s assessment of the borrower’s long-run average propensity to default in the next year.
- PIT PD, which reflects current economic, industry and borrower circumstances; and

Both types of PDs are used extensively in the Group’s decision-making processes and several types of rating approaches are employed across the Group.

Assessment of credit risk *(continued)*

Probability of default (PD) *(continued)*

For communication and comparison purposes, the Group maps its 21 default grades (DG), which is the Group's internal master rating scale, to the SARB 26 grade PD scale which is used for regulatory reporting purposes. An indicative mapping of the DG buckets to the equivalent international rating agency and regulatory PD bands are set out in the following table.

Mapping of DG to PD band, alphanumeric agency grades and regulatory bands

		Absa DG to PD mapping			Alphanumeric scale mapping		
Default grade bucket	Note	Min PD (>) %	Max PD (<) %	PD Midpoint %	Standard & Poor's	Moody's	Fitch
1	1	0,0000	0,0200	0,0100	AAA	Aaa	AAA
2		0,0200	0,0300	0,0250	AA	Aa	AA
3		0,0300	0,0500	0,0400	A+	A1	A+
4		0,0500	0,1000	0,0750	A/A–	A2/A3	A/A–
5		0,1000	0,1500	0,1250	BBB+	Baa1	BBB+
6		0,1500	0,2000	0,1750	BBB+/BBB	Baa1/Baa2	BBB+/BBB
7		0,2000	0,2500	0,2250	BBB	Baa2	BBB
8		0,2500	0,3000	0,2750	BBB/BBB–	Baa2/Baa3	BBB/BBB–
9		0,3000	0,4000	0,3500	BBB–	Baa3	BBB–
10	2	0,4000	0,5000	0,4500	BBB–/BB+	Baa3/Ba1	BBB–/BB+
11		0,5000	0,6000	0,5500	BB+	Ba1	BB+
12		0,6000	1,2000	0,9000	BB	Ba2	BB
13		1,2000	1,5500	1,3750	BB/BB–	Ba2/Ba3	BB/BB–
14		1,5500	2,1500	1,8500	BB/BB–	Ba2/Ba3	BB/BB–
15		2,1500	3,0500	2,6000	BB–	Ba3	BB–
16		3,0500	4,4500	3,7500	B+	B1	B+
17		4,4500	6,3500	5,4000	B+/B	B1/B2	B+/B
18		6,3500	8,6500	7,5000	B	B2	B
19		8,6500	11,350	10,0000	B–	B3	B–
20	3	11,350	18,650	15,0000	CCC+	Caa1	CCC+
21		18,650	100,00	30,0000	CCC	Caa2	CCC
Default		100,00	100,00	100,00	D	D	D

Regulatory PD band to PD mapping		
PD band	Lower bound %	Upper bound %
1	0,0001	0,0120
2	0,0121	0,0170
3	0,0171	0,0240
4	0,0241	0,0340
5	0,0341	0,0480
6	0,0481	0,0670
7	0,0671	0,0950
8	0,0951	0,1350
9	0,1351	0,1900
10	0,1901	0,2690
11	0,2691	0,3810
12	0,3811	0,5380
13	0,5381	0,7610
14	0,7611	1,0760
15	1,0761	1,5220
16	1,5221	2,1530
17	2,1531	3,0440
18	3,0441	4,3050
19	4,3051	6,0890
20	6,0891	8,6110
21	8,6111	12,177
22	12,178	17,222
23	17,223	24,355
24	24,356	34,443
25	34,444	100,00
Default	100,00	100,00

Notes

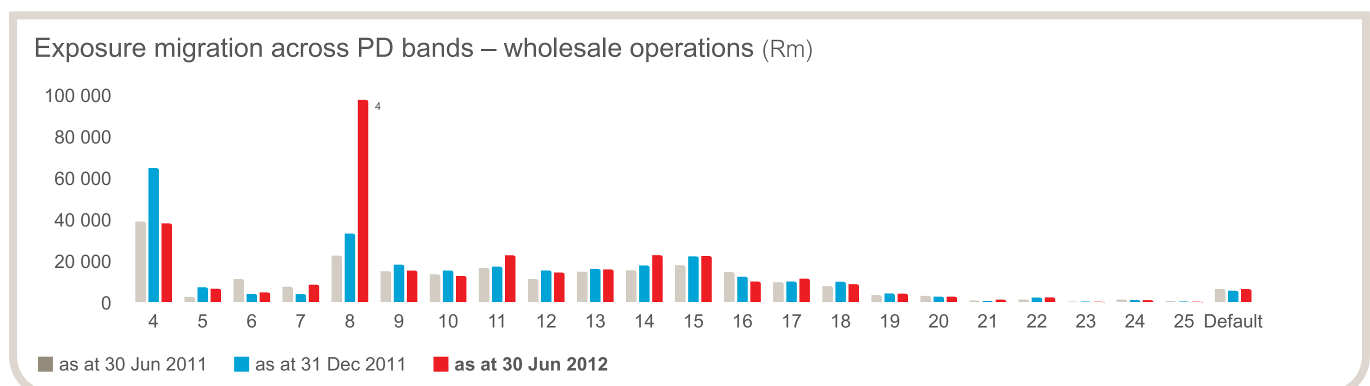
[1]Default grades 1 – 10: assets falling within these DG buckets are regarded as 'investment grade' and, when converted to a rating agency equivalent, correspond to a BB rating and better.

[2]Default grades 10 – 19: financial assets in these grades typically require more detailed management attention where clear evidence of financial deterioration or weakness exists. Assets in this category, although currently protected, are potentially weaker credits. These assets contain some credit deficiencies.

[3]Default grades 20 – 21: the PD of financial assets in these grades have deteriorated to such an extent that they are included for regular review. Assets so classified must have well defined weaknesses that exacerbate the PD. These assets are characterised by the distinct possibility that the borrower will default, and should the collateral pledged be insufficient to cover the asset, the Group will sustain some loss when default occurs.

The Group DG grading represents a TTC view of the distribution of the book.

The following graphs provide a view of PD migration for wholesale and retail exposures:

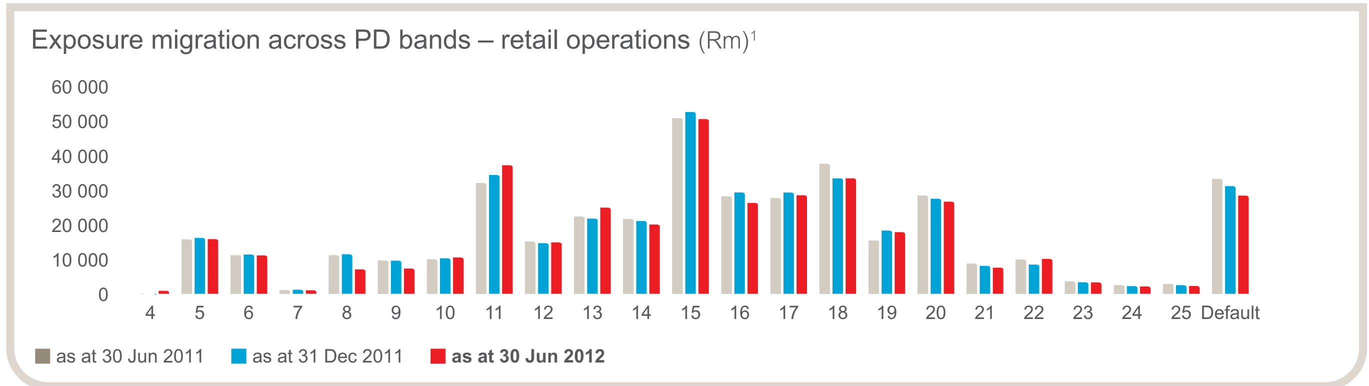


[4]Increase as a result of the statutory reserve and liquid asset portfolio moving from the standardised to AIRB approach.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Probability of default (PD) *(continued)*



Expected/predicted versus actual loss analysis

The purpose of the following sections (PD, EAD and EL) is to provide a view of the performance of the Basel models.

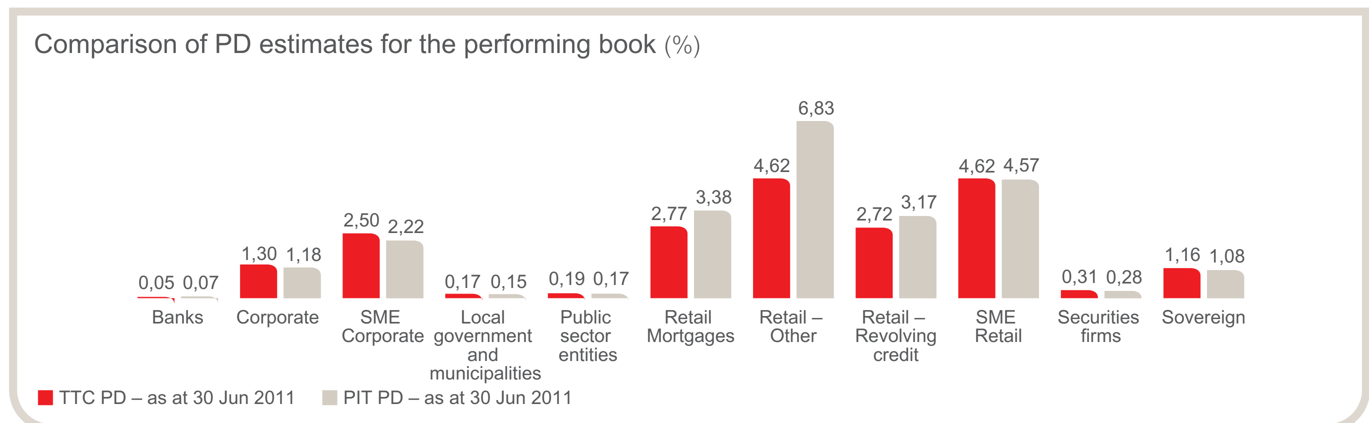
Probability of default

Comparison of PD estimates with actual default

The objective of PD backtesting is to compare the accuracy of the PD estimates for regulatory purposes with the actual default data.

For each retail and wholesale asset class in terms of Basel II.5, the assigned PD for regulatory capital purposes as at 30 June 2011 is compared to the actual non-performing loans observed at 30 June 2012.

Regulatory PD is adjusted TTC while the non-performing loans ratio is observed at a particular point in the cycle which is 30 June 2012. To complete the analysis, the observed NPL ratio is also compared to the point-in-time 30 June 2011 probability of default. A comparison between the TTC PD and PIT PD as at 30 June 2011 for the performing book only (i.e. defaults excluded) is provided below.



Note

[1]Woolworths Financial Services is excluded from this analysis.

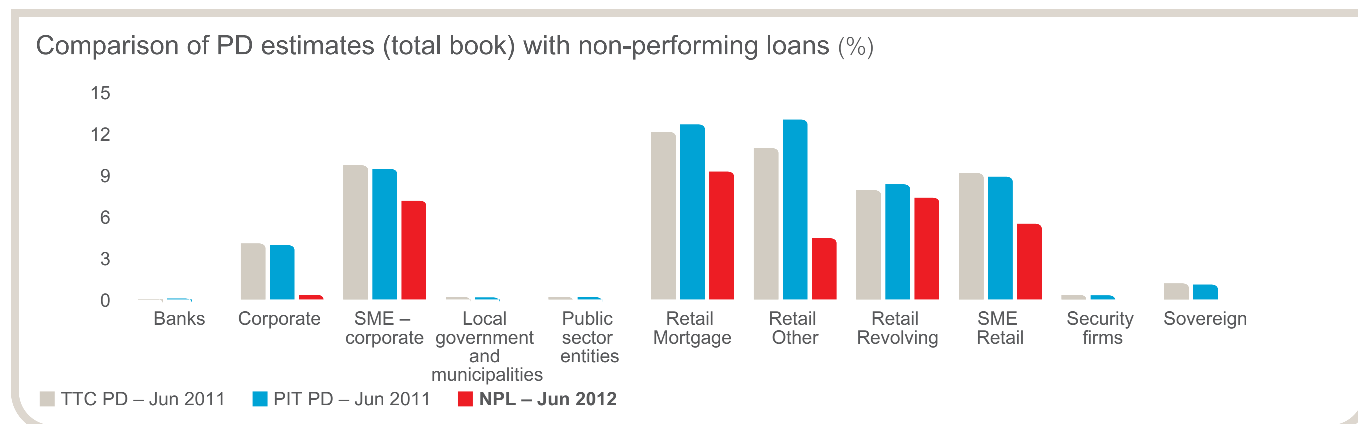
Assessment of credit risk *(continued)*

Expected/predicted versus actual loss analysis *(continued)*

Probability of default *(continued)*

Comparison of PD estimates with actual default *(continued)*

Comparison of PD estimates (total book) with non-performing loans (%)



The main conclusions of the analysis are as follows:

- The regulatory or TTC PD as at 30 June 2011 is above the non-performing loans ratio observed at 30 June 2012 for all asset classes.
- The PIT PD as at 30 June 2011, i.e. the point-in-time- estimates of the model, is above the non-performing loans ratio observed at 30 June 2012 for all asset classes.
- Except for SME Retail, the overall PIT PD for the retail asset classes is still higher than the TTC PD as at 30 June 2011, while it has moved below the TTC PD in the case of wholesale asset classes.

EAD

The EAD denotes the total amount the Group expects will be outstanding from a particular customer at the time of default. The Group calculates these estimates for each facility using models incorporating internal and external default data as well as the experience of credit experts in relation to particular products or customer groups.

EAD estimates incorporate both on- and off-statement of financial position exposures resulting in a capital requirement which incorporates existing exposures, as well as exposures contingent on a counterparty's use of an available facility.

Comparison of EAD estimates with actual exposure of defaults

The objective of EAD backtesting is to compare the accuracy of EAD estimates for regulatory purposes with actual EAD.

For each retail and wholesale Basel II.5 asset class, the estimated EAD (Rm) at 30 June 2011 is compared to the actual EAD at 30 June 2012.

EAD models for VAF, Personal Loans and Platinum 1 were implemented prior to 30 June 2012. The wholesale AIRB EAD model was introduced on 1 January 2012.

The main conclusion of the analysis is that the actual EAD as at 30 June 2011 is lower than the estimated EAD at 30 June 2012 in all cases (37% and 21% lower in total for retail and wholesale asset classes respectively).

Note

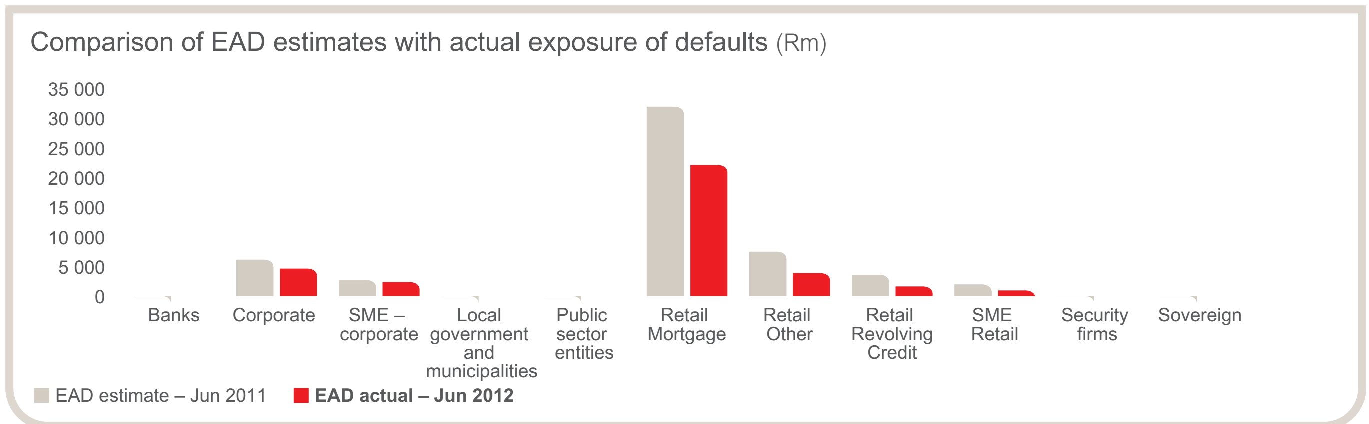
[1]Woolworths Financial Services is excluded from this analysis.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Expected/predicted versus actual loss analysis *(continued)*

EAD *(continued)*



The PD, EAD and LGD are components used in a variety of applications that measure credit risk across the entire portfolio. EL is a measurement of loss which enables the application of consistent credit risk measurement across all retail and wholesale credit exposures.

These components are the basis for RC and EC calculations. EL figures are calculated as the product of TTC PD, EAD and downturn LGD and represent the Group's best estimate of losses over the next twelve months based on long-run estimates that span an entire business cycle.

These estimates are also used in a range of applications including pricing, customer and portfolio strategy and performance measurement. EL estimates are compared to impairment figures, but it should be noted that while they may be similar, they are calculated on a different basis and for distinctly different purposes and should therefore not be expected to match one another.

EL is therefore a statistical estimate of the average loss for the loan portfolio over the next twelve months, based on a long-term average loss tendency that incorporates at least one business cycle. This type of measure therefore provides a measure of loss independent of the current credit conditions for a particular customer type, and is more stable over time. It is primarily used in capital measurement processes.

LGD

The third major risk component measures the loss expected on a particular credit facility in the event of default and therefore recognises credit risk mitigants which the Group may employ, such as collateral or credit risk derivatives. LGD estimates are calculated as a percentage of EAD using models based on internal and external loss data and the judgement of credit experts, and are primarily driven by the type and value of collateral held. The Group modifies its LGD estimates to distinguish between expected losses over the course of an economic cycle and loss estimates during periods of economic stress (downturn LGD).

Note

[1]Woolworths Financial Services is excluded from this analysis.

Assessment of credit risk *(continued)*

Expected loss (EL) and capital requirements

Expected losses compared to actual write-offs

The objective of EL backtesting is to compare the accuracy of the EL estimates with actual write-off data.

For each retail and wholesale asset class in terms of Basel II.5, the estimated EL as at 30 June 2011 is compared to the actual amount written off during the reporting period.

EL is a function of TTC PD, downturn LGD and EAD (EL = TTC PD x downturn LGD x EAD), i.e. it is a TTC measure adjusted for an economic downturn while the amount written off is observed over a twelve-month period 1 July 2011 to 30 June 2012.

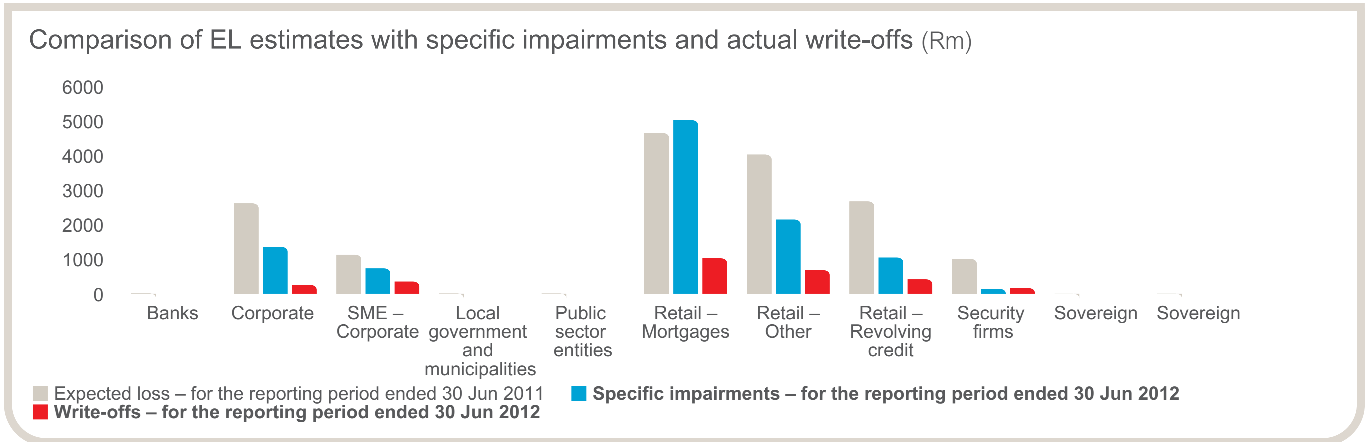
Recalibrated LGD models for home loans and cheques were implemented prior to 30 June 2012. The wholesale AIRB LGD model was introduced on 1 January 2012.

Assessment of credit risk *(continued)*

Expected loss (EL) and capital requirements *(continued)*

Expected losses compared to actual write-offs *(continued)*

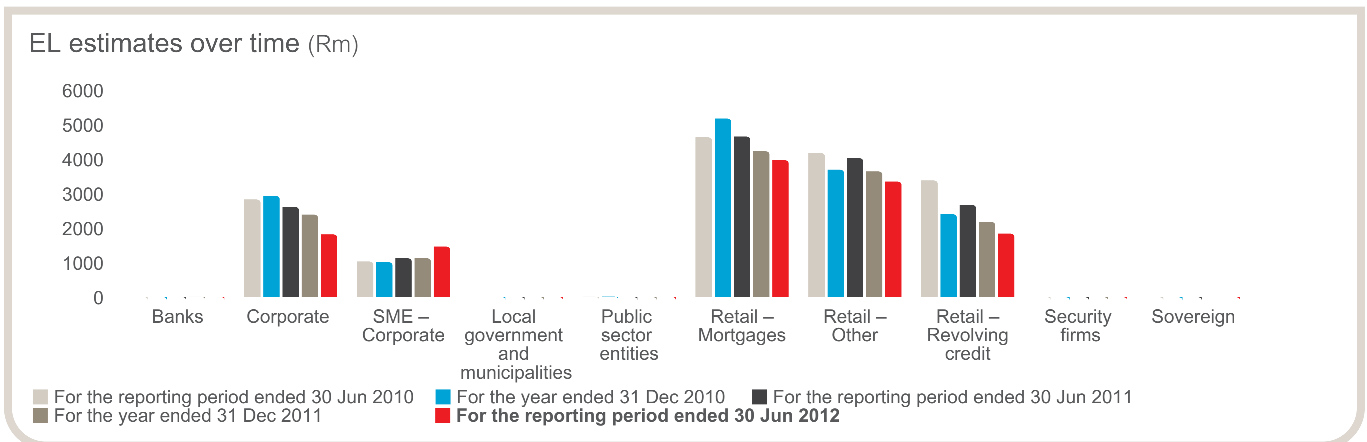
Comparison of EL estimates with actual write-offs



The main conclusions of the analysis:

- The actual write-offs observed for the period ending 30 June 2012 are below the specific impairment levels (as at 30 June 2012) and EL estimates (as at 30 June 2011) for all asset classes
- Except for Retail Mortgages, specific impairments as at 30 June 2012 are lower than the EL estimates as at 30 June 2011.

Trend analysis of EL, specific impairment and write-offs:



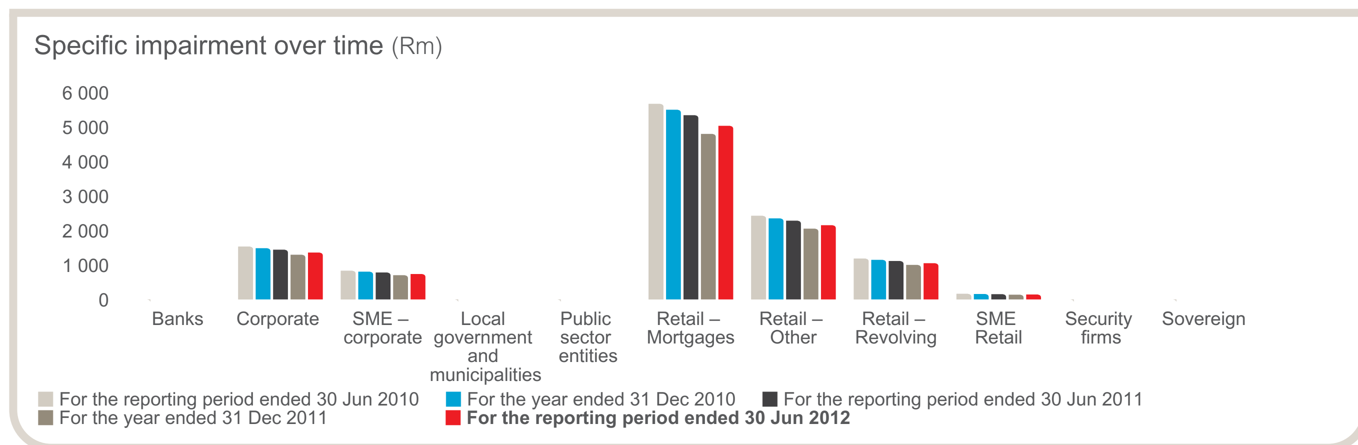
Assessment of credit risk *(continued)*

Expected loss (EL) and capital requirements *(continued)*

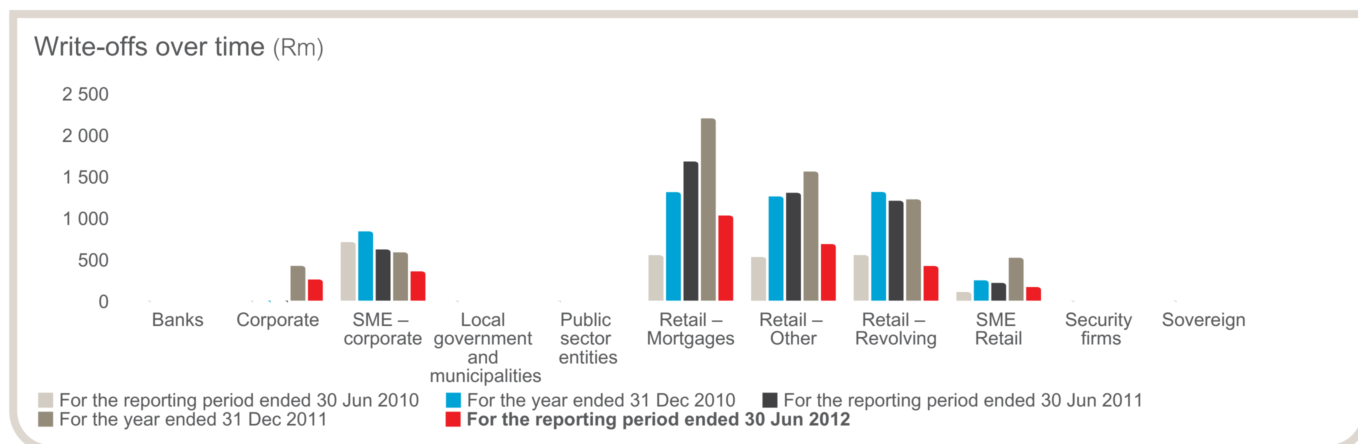
Expected losses compared to actual write-offs (continued)

Trend analysis

Specific impairment over time (Rm)



Write-offs over time (Rm)



Retail and wholesale credit risk

Assessment of credit risk *(continued)*

PD, EAD and LGD analysis in terms of regulatory disclosure requirements

Analysis by PDs, EADs and LGDs by risk grade under the AIRB approach – Wholesale portfolio[1]

	30 June 2011	30 June 2012													
			Banks				Corporate				SME Corporate				
Risk grade	Average PD %	Average PD %	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm
Non-default	1,16	0,90	43,50	22,35	10	41 428	37,57	61,12	587	156 669	43,93	82,39	410	32 104
4	0,03	0,03	43,36	19,34	4	30 979	40,64	15,61	1	6 033	44,39	11,72	0	1
5	0,04	0,04	43,91	14,95	0	573	43,95	45,17	1	5 721	53,57	11,45	0	86
6	0,05	0,05	43,91	15,92	0	543	40,34	13,49	1	4 024	18,62	12,95	0	24
7	0,08	0,08	43,91	37,86	1	1 991	43,63	20,41	1	6 334	56,60	18,85	0	9
8	0,11	0,12	43,91	29,09	4	6 563	36,92	24,31	5	11 850	20,39	18,06	0	42
9	0,16	0,16	43,91	25,97	0	6	40,22	39,20	9	13 923	33,49	26,70	0	138
10	0,22	0,22	43,91	31,54	0	451	37,24	44,06	8	9 203	40,47	35,64	2	2 155
11	0,32	0,31	43,91	88,64	0	194	36,57	47,62	19	16 808	41,58	44,97	4	3 125
12	0,45	0,44	43,91	52,51	0	15	38,59	55,24	17	9 845	38,48	50,64	5	3 133
13	0,63	0,61	—	—	—	—	38,60	69,20	30	12 914	41,18	63,32	6	2 413
14	0,91	0,89	43,91	73,07	0	50	38,09	79,41	58	18 747	39,67	69,33	13	3 536
15	1,26	1,30	43,91	102,91	0	0	29,82	73,57	68	18 049	35,76	71,24	14	3 101
16	1,82	1,84	43,91	95,73	0	0	36,90	96,45	39	5 904	42,07	88,77	21	2 757
17	2,53	2,63	43,91	107,16	1	50	39,17	115,03	76	7 489	45,72	109,66	43	3 603
18	3,64	3,77	43,91	120,70	0	1	36,93	113,48	45	3 596	59,79	110,92	101	4 283
19	5,23	5,17	43,91	135,49	0	1	39,21	135,62	53	2 603	43,47	110,44	27	1 232
20	7,00	7,03	43,91	164,98	0	11	36,17	143,19	34	1 388	43,58	139,87	33	1 089
21	9,98	9,27	43,91	181,80	0	0	31,21	137,95	27	938	44,91	158,47	9	200
22	14,03	14,62	—	—	—	—	31,99	168,50	23	506	53,54	155,04	62	765
23	20,62	19,41	10,34	100,00	0	0	48,01	256,49	4	50	56,06	217,84	10	94
24	29,82	30,01	43,91	244,24	0	0	27,28	162,66	56	680	59,60	206,71	41	225
25	39,88	39,67	—	—	—	—	46,26	256,98	12	64	50,68	253,26	19	93
Default	100,00	100,00	—	—	—	—	26,59	116,61	1 306	4 150	42,55	132,09	776	2 002
Total	3,82	2,79	43,50	22,35	10	41 428	37,29	62,55	1 893	160 819	43,85	85,30	1 186	34 106

Note

[1]Amounts indicated as zero in the above table, reflect values less than R1 million.

Assessment of credit risk *(continued)*

PD, EAD and LGD analysis in terms of regulatory disclosure requirements

Analysis by PDs, EADs and LGDs by risk grade under the AIRB approach – Wholesale portfolio[1]

30 June 2012

Specialised lending – income producing real estate				Specialised lending – project finance				Local governments and municipalities				Public sector entities			
LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm
19,50	67,21	31	2 892	35,56	78,44	17	5 331	17,09	14,95	2	10 103	23,64	20,09	4	6 445
—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	38,35	13,63	0	4	46,00	11,42	0	0
14,33	10,39	0	9	—	—	—	—	—	—	—	—	5,00	4,17	0	28
10,00	8,19	0	4	—	—	—	—	45,00	31,72	0	1	—	—	—	—
18,42	21,77	0	42	43,91	55,78	0	604	15,78	12,38	2	9 633	22,00	15,96	1	5 046
13,09	16,00	0	21	—	—	—	—	45,00	45,33	0	134	37,02	24,98	1	854
17,96	19,36	0	134	43,91	51,48	0	154	44,99	58,80	0	125	5,21	4,39	0	44
10,91	19,02	0	36	28,93	49,67	2	2 178	40,63	56,03	0	72	14,78	26,06	0	111
16,17	30,92	0	301	43,91	76,87	1	403	45,00	86,75	0	35	45,96	91,96	0	17
4,08	9,68	0	26	25,00	60,07	0	279	44,95	102,56	0	66	15,72	21,02	0	3
16,95	41,66	0	237	0,00	100,00	0	0	44,22	88,55	0	0	25,00	41,19	0	1
23,41	58,71	2	757	15,00	47,40	0	229	45,00	94,24	0	1	5,00	15,07	0	1
17,67	49,17	0	3	43,91	133,99	9	1 081	45,00	131,00	0	4	5,02	11,90	0	95
24,94	90,78	0	43	—	—	—	—	41,49	122,69	0	15	33,39	120,71	0	44
20,41	65,79	2	234	43,91	161,16	5	403	42,26	154,20	0	12	22,66	84,89	0	39
10,00	34,25	0	2	—	—	—	—	18,89	44,37	0	0	25,00	80,05	2	162
21,81	81,60	1	95	—	—	—	—	45,00	214,44	0	0	—	—	—	—
20,04	82,25	0	1	—	—	—	—	—	—	—	—	—	—	—	—
18,63	103,96	26	947	—	—	—	—	38,40	187,94	0	0	—	—	—	—
10,00	0,00	0	0	—	—	—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	45,00	283,92	0	0	—	—	—	—
—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
—	—	—	—	43,91	80,37	50	75	—	—	—	—	—	—	—	—
19,50	67,21	31	2 892	35,67	78,46	67	5 406	17,09	14,95	2	10 103	23,64	20,09	4	6 445

Note

[1]Amounts indicated as zero in the above table, reflect values less than R1 million.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

PD, EAD and LGD analysis in terms of regulatory disclosure requirements

Analysis by PDs, EADs and LGDs by risk grade under the AIRB approach – Wholesale portfolio[1]

	30 June 2012												30 June 2011
	Securities firm				Sovereign				Total				
	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	EAD Rm
	43,91	39,35	1	1 405	5,61	5,58	4	64 030	31,50	45,10	1 066	320 406	226 079
	43,91	7,84	0	457	25,18	13,86	0	441	42,73	18,54	5	37 911	38 752
	—	—	—	—	—	—	—	—	44,07	41,99	1	6 384	2 436
	41,86	40,00	0	0	—	—	—	—	40,38	13,71	1	4 628	11 012
	0,00	100,00	0	0	—	—	—	—	43,69	24,57	2	8 339	7 327
	43,91	20,35	0	82	5,47	5,48	4	63 576	14,04	10,92	17	97 438	22 284
	43,91	42,76	0	70	—	—	—	—	40,01	38,32	10	15 146	14 773
	43,91	68,88	0	297	5,00	4,25	0	0	38,04	42,59	10	12 563	13 304
	43,91	43,91	0	1	—	—	—	—	36,46	47,68	26	22 525	16 393
	43,91	47,74	1	452	—	—	—	—	38,44	54,20	24	14 201	11 021
	—	—	—	—	—	—	—	—	38,72	68,17	36	15 701	14 554
	43,91	74,14	0	1	—	—	—	—	38,13	77,42	71	22 572	15 225
	43,91	117,90	0	26	—	—	—	—	30,29	72,52	84	22 164	17 657
	43,91	95,71	0	19	—	—	—	—	38,81	97,60	69	9 863	14 367
	0,00	100,00	0	0	5,00	12,19	0	0	41,21	113,21	120	11 244	9 473
	—	—	—	—	43,91	173,13	0	13	48,17	113,16	154	8 581	7 625
	—	—	—	—	—	—	—	—	39,94	125,57	82	4 000	3 272
	—	—	—	—	—	—	—	—	38,80	139,63	68	2 583	2 924
	—	—	—	—	—	—	—	—	33,61	141,51	36	1 139	650
	—	—	—	—	—	—	—	—	33,72	136,30	111	2 218	1 173
	—	—	—	—	—	—	—	—	53,27	231,23	14	144	215
	—	—	—	—	—	—	—	—	35,32	173,64	97	906	1 205
	—	—	—	—	—	—	—	—	48,88	254,77	31	158	437
	—	—	—	—	—	—	—	—	31,93	121,15	2 132	6 227	6 255
	43,91	39,35	1	1 405	5,61	5,58	4	64 030	31,50	46,55	3 201	326 635	232 334

Note

[1]Amounts indicated as zero in the above table, reflect values less than R1 million.

Assessment of credit risk *(continued)*

PD, EAD and LGD analysis in terms of regulatory disclosure requirements *(continued)*

Analysis by PDs, EADs and LGDs by risk grade under the AIRB approach – Retail portfolios

	30 June 2011	30 June 2012												
			Residential mortgages advances (including home equity line of credit)				Retail – other vehicle and asset finance				Retail – other unsecured lending <= 30 000			
Risk grade	Average PD %	Average PD %	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm
Non-default	3,20	3,06	13,91	25,25	904	238 431	38,33	49,75	497	42 514	74,67	101,07	201	4 905
4	0,03	0,03	—	—	—	—	32,90	11,19	0	865	—	—	—	—
5	0,04	0,04	10,92	1,25	0	11 634	40,82	4,76	0	165	71,98	8,35	0	175
6	0,05	0,05	11,22	1,69	1	10 930	—	—	—	—	—	—	—	—
7	0,08	0,08	—	—	—	—	37,99	9,27	0	479	82,03	16,77	0	124
8	0,11	0,11	11,73	3,25	0	1 194	38,72	10,27	0	900	73,70	23,39	0	103
9	0,16	0,16	12,91	4,79	1	4 962	—	—	—	—	72,37	27,49	0	43
10	0,23	0,23	14,82	7,07	4	10 123	42,17	22,02	0	1	—	—	—	—
11	0,32	0,32	13,79	8,11	15	35 118	37,69	21,89	0	252	73,57	41,58	0	207
12	0,45	0,45	12,56	9,56	5	9 221	38,48	28,59	7	3 598	75,86	52,56	0	72
13	0,66	0,66	14,11	14,15	21	22 565	38,15	33,08	1	422	73,66	62,25	1	246
14	0,90	0,90	13,93	17,32	14	11 440	38,37	40,06	10	2 794	76,27	76,12	1	212
15	1,24	1,24	14,19	21,61	66	37 845	38,19	45,56	16	3 299	78,56	92,05	8	838
16	1,80	1,80	14,31	28,01	42	16 370	38,82	51,87	45	6 219	75,43	100,79	4	259
17	2,55	2,54	14,47	33,43	42	11 330	37,96	54,53	87	11 502	74,07	105,65	6	336
18	3,80	3,77	14,59	42,61	63	11 916	38,96	47,12	—	3 689	78,17	118,68	19	642
19	5,21	5,12	14,36	50,81	88	11 938	38,44	60,28	48	2 458	74,64	116,50	10	277
20	7,45	7,41	14,97	62,74	222	20 307	38,60	64,54	82	2 687	75,97	123,56	19	355
21	9,49	9,65	14,98	70,95	69	4 766	38,14	66,61	39	1 080	74,29	130,43	10	137
22	14,90	14,77	14,78	81,53	45	2 084	38,94	81,28	71	1 221	64,98	136,82	61	609
23	21,03	20,80	16,11	96,66	73	2 157	40,00	95,65	39	475	72,93	175,80	8	50
24	28,99	29,24	15,23	94,10	53	1 169	39,74	105,89	30	263	74,73	200,43	34	159
25	39,78	40,21	15,54	93,26	80	1 362	41,23	115,34	22	145	72,26	194,92	20	61
Default	100,00	100,00	15,33	7,02	4 970	22 105	62,45	216,22	1 151	2 303	77,03	175,28	236	417
Total	11,27	10,17	14,03	23,70	5 874	260 536	39,57	58,30	1 648	44 817	74,85	106,88	437	5 322

Note

Amounts indicated as zero in the above table, reflect values less than R1 million.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

PD, EAD and LGD analysis in terms of regulatory disclosure requirements *(continued)*

Analysis by PDs, EADs and LGDs by risk grade under the AIRB approach – Retail portfolios

30 June 2012

Retail – other unsecured lending > 30 000				Retail Revolving credit – credit cards				Retail Revolving credit – non-credit cards				SME Retail – Secured lending			
LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm
72,13	104,28	694	15 963	74,14	65,79	898	31 467	81,86	24,32	53	6 897	22,02	31,67	127	8 150
—	—	—	—	—	—	—	—	—	—	—	—	39,39	4,13	0	1
77,05	8,94	0	209	71,48	1,84	0	3	82,03	2,11	1	2 870	34,43	4,93	0	10
—	—	—	—	—	—	—	—	82,02	3,71	0	7	11,83	2,17	0	176
82,03	16,77	0	115	77,21	4,38	0	1	82,03	3,94	0	304	17,93	4,05	0	0
76,40	24,25	0	271	70,57	4,88	4	4 578	78,37	5,88	0	3	28,87	8,29	0	1
73,14	28,25	0	74	69,06	6,34	2	2 197	78,13	7,14	0	12	38,12	14,00	0	4
82,03	35,58	0	5	78,90	8,93	0	1	81,93	9,22	1	349	17,25	8,31	0	19
76,70	43,80	1	527	77,40	13,38	0	154	81,81	14,98	1	482	26,29	16,11	0	26
77,64	54,12	1	189	76,52	17,43	0	17	81,31	17,22	0	63	14,19	9,76	1	1 323
76,54	63,76	3	701	76,53	20,78	0	1	81,57	22,65	2	370	27,73	24,36	0	58
78,05	77,95	5	696	74,75	27,34	20	3 037	81,71	30,73	4	476	16,36	16,66	1	949
79,57	92,88	25	2 600	74,83	35,99	7	702	81,79	40,46	10	902	18,49	21,04	4	2 066
77,82	103,18	13	907	75,42	44,72	14	1 156	81,44	54,28	4	245	34,71	46,33	1	226
76,88	109,85	22	1 160	76,37	58,79	35	1 917	81,77	67,02	5	234	33,78	48,78	5	542
79,48	120,76	60	2 012	74,35	82,76	383	12 737	81,73	88,07	12	369	23,66	35,99	11	1 246
76,59	119,56	29	769	76,28	98,24	66	1 732	81,76	105,68	4	87	36,47	57,07	2	99
76,75	124,39	48	899	77,36	125,70	72	1 284	81,55	132,01	4	67	22,66	37,00	8	505
76,66	134,41	23	313	78,01	155,48	51	644	81,98	166,45	5	55	38,07	68,69	2	52
53,96	113,85	324	3 893	78,45	186,69	70	624	80,19	189,60	0	1	20,51	41,06	13	468
77,06	185,44	29	181	78,75	219,35	53	331	81,61	229,23	0	2	49,53	120,59	0	3
77,03	208,19	81	348	79,43	244,82	30	138	78,07	241,85	0	0	41,50	111,36	0	3
74,62	204,62	30	94	78,90	236,70	91	213	81,88	265,05	0	0	51,39	144,61	79	372
78,62	187,02	764	1 142	74,69	113,93	1 005	1 521	100,00	501,78	49	95	20,67	112,28	66	360
72,57	109,81	1 458	17 105	74,17	68,01	1 903	32 988	82,11	30,80	102	6 992	21,96	35,08	193	8 510

Note

Amounts indicated as zero in the above table, reflect less smaller than R1 million.

Assessment of credit risk *(continued)*

PD, EAD and LGD analysis in terms of regulatory disclosure requirements *(continued)*

Analysis by PDs, EADs and LGDs by risk grade under the AIRB approach – Retail portfolios

30 June 2012								30 June 2011
SME Retail – Unsecured lending				Total				
LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	LGD %	Exposure weighted average risk weight %	Expected loss Rm	EAD Rm	EAD Rm
65,45	63,71	266	11 004	28,55	37,55	3 640	359 331	365 548
—	—	—	—	32,91	11,18	0	866	2
81,83	2,18	0	751	29,07	1,67	1	15 817	15 754
—	—	—	—	11,28	1,70	1	11 113	11 143
82,01	3,95	0	0	61,40	9,42	0	1 023	1 069
79,56	6,59	0	21	56,87	6,31	4	7 071	11 151
52,75	15,69	0	12	30,95	5,66	3	7 305	9 585
50,23	19,65	0	20	17,16	7,19	5	10 514	9 982
74,42	18,07	1	418	17,01	9,13	18	37 184	32 008
64,63	23,05	1	387	21,84	15,35	15	14 870	15 075
66,06	32,78	2	565	19,07	16,91	30	24 928	22 346
56,85	44,08	2	437	32,10	25,61	57	20 041	21 662
77,09	44,81	23	2 278	25,25	29,57	159	50 530	50 789
67,95	56,78	11	913	28,25	39,10	134	26 295	28 192
46,97	67,73	19	1 484	33,96	49,96	221	28 505	27 688
70,18	83,86	21	791	47,60	65,82	569	33 402	37 604
67,97	96,97	17	472	29,19	62,23	264	17 832	15 431
69,02	118,48	30	552	24,69	69,68	485	26 656	28 426
70,05	124,44	35	522	31,71	85,59	234	7 567	8 737
45,92	93,93	73	1 197	43,73	103,40	657	10 097	9 942
63,09	165,03	14	108	31,62	117,20	216	3 307	3 610
76,30	223,82	12	59	38,58	135,33	240	2 139	2 489
76,85	239,05	5	17	33,48	125,06	327	2 264	2 863
63,63	262 19	77	466	26,92	46,57	8 318	28 408	33 247
65,38	71,77	343	11 470	28,44	38,21	11 958	387 740	398 795

Note

Amounts indicated as zero in the above table, reflect values less than R1 million.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Gross exposures per Basel II,5 approach and asset class

	30 June 2012						30 June 2011	31 December 2011
Standardised approach	Utilised (on-statement of financial position exposure) Rm	Off-balance sheet exposure Rm	Repurchase and resale agreements Rm	Derivative instruments Rm	Total credit exposure Rm	EAD[1] Rm	EAD Rm	EAD[2] Rm
Corporate								
SME Corporate exposure	4 235	1 023			5 258	5 258	5 295	8 137
Banks	2 995	—	—	—	2 995	2 995	1 736	1 802
Public sector entities	—	—	—	—	—	—	168	—
Local government and municipalities	0	—	—	—	0	0	—	1
Sovereign	2 559	—	—	—	2 559	2 559	52 641	58 843
Retail	2 135	—	—	—	2 135	2 135	1 255	1 232
– Mortgages (including any home equity line of credit)	114	—	—	—	114	114	—	—
– Retail revolving	—	—	—	—	—	—	—	—
Credit cards[3]	—	—	—	—	—	—	n/a	n/a
Non credit cards[3]	—	—	—	—	—	—	n/a	n/a
– SME Retail	—	—	—	—	—	—	—	—
Secured lending[3]	—	—	—	—	—	—	n/a	n/a
Unsecured lending[3]	—	—	—	—	—	—	n/a	n/a
– Retail – other	2 021	—	—	—	2 021	2 021	—	—
Vehicle and asset finance[3]	—	—	—	—	—	—	n/a	n/a
Unsecured lending[3] <= 30 000	—	—	—	—	—	—	n/a	n/a
Unsecured lending[3] > 30 000	2 021	—	—	—	2 021	2 021	n/a	n/a
Securities firms	—	—	—	—	—	—	—	—
	11 924	1 023	—	—	12 947	12 947	61 095	70 015

Notes

[1]The Group's statutory liquid asset portfolio moved from the standardised approach to the AIRB approach with effect from January 2012 resulting in the year-on-year decrease.

[2]In line with guidance received from the SARB, the Group amended its risk treatment of mandatory reserves for African entities, which resulted in an increase in the RWA in the standardised credit portfolio, from June 2011 to December 2011.

[3]Basel II.5 reporting requirement, prior period comparatives not available.

Assessment of credit risk *(continued)*

Gross exposures per Basel II,5 approach and asset class *(continued)*

	30 June 2012						30 June 2011	31 December 2011
AIRB approach	Utilised (on-balance sheet exposure) Rm	Off-balance sheet exposure Rm	Repurchase and resale agreements Rm	OTC derivative instruments Rm	Total credit exposure Rm	EAD Rm	EAD[1] Rm	EAD[1] Rm
Corporate[1]	162 269	103 542	990	7 800	274 601	203 221	179 213	200 947
Large Corporate	126 860	93 410	990	7 659	228 919	160 818	145 553	160 385
SME Corporate	28 129	6 698	—	—	34 827	34 107	27 628	32 149
Specialised lending – income producing real estate	2 793	1 369	—	—	4 162	2 890	1 869	2 973
Specialsed lending – project finance	4 487	2 065	—	141	6 693	5 406	4 163	5 440
Banks[1]	29 321	44 039	20 709	37 932	132 001	41 427	35 684	61 571
Local government and municipalities[1]	7 293	7 623	—	—	14 916	10 103	7 851	9 505
Public sector entities[1]	3 425	13 027	294	1 690	18 436	6 444	7 993	6 720
Sovereign[1]	62 131	787	—	85	63 003	64 031	866	1 195
Retail	351 612	88 464	—	—	440 076	387 736	398 795	397 978
– Mortgages (including any home equity line of credit)	242 763	51 848	—	—	294 611	260 535	263 837	264 883
– Retail revolving	25 606	27 905	—	—	53 511	39 978	45 375	46 451
Credit cards[2]	23 965	23 837	—	—	47 802	32 985	n/a	n/a
Non credit cards[2]	1 641	4 068	—	—	5 709	6 993	n/a	n/a
– SME retail	15 076	6 930	—	—	22 006	19 980	21 219	20 400
Secured lending[2]	8 203	1 083	—	—	9 286	8 510	n/a	n/a
Unsecured lending[2]	6 873	5 847	—	—	12 720	11 470	n/a	n/a
– Retail – other	68 167	1 781	—	—	69 948	67 243	68 364	66 244
Vehicle and asset finance[2]	47 920	—	—	—	47 920	44 816	n/a	n/a
Unsecured lending[2] <= 30 000	4 384	505	—	—	4 889	5 321	n/a	n/a
Unsecured lending[2] > 30 000	15 863	1 276	—	—	17 139	17 106	n/a	n/a
Securities firms[1]	332	8 146	13 536	1 255	23 269	1 405	727	1 342
	616 383	265 628	35 529	48 762	966 302	714 367	631 129	679 258

Note

[1]June 2011 and December 2011 comparative numbers for these asset classes are reflective of the FIRB approach being used at the time.

[2]Basel II,5 reporting requirements, prior reporting period, comparatives not available.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Analysis of past due exposures[1]

	30 June			
	2012			
	Days overdue			
	0 – 30 days Total EAD Rm	31 – 60 days Total EAD Rm	61 – 90 days Total EAD Rm	>90 days Total EAD Rm
Corporate	3 024	532	578	6 228
Banks	12	—	—	—
Public sector entities	6	1	1	—
Local governments and municipalities	197	4	23	—
Retail	14 393	3 275	2 269	24 295
Sovereign	2	8	—	—
Securities firms	—	—	—	—
	17 634	3 820	2 871	30 523

	30 June			
	2011			
	Days overdue			
	0 – 30 days Total EAD Rm	31 – 60 days Total EAD Rm	61 – 90 days Total EAD Rm	>90 days Total EAD Rm
Corporate	2 711	209	233	6 255
Banks	—	—	—	—
Public sector entities	—	—	—	—
Local governments and municipalities	—	—	—	232
Retail exposure	8 261	4 482	2 336	33 247
Sovereign	—	—	—	—
Securities firms	—	—	—	—
	10 972	4 691	2 559	39 734

	31 December			
	2011			
	Days overdue			
	0 – 30 days Total EAD Rm	31 – 60 days Total EAD Rm	61 – 90 days Total EAD Rm	>90 days Total EAD Rm
Corporate	2 530	761	252	5 427
Banks	2	—	—	—
Public sector entities	3	1	1	—
Local governments and municipalities	24	3	613	—
Retail exposure	14 201	3 518	2 232	31 144
Sovereign	—	—	—	—
Securities firms	—	—	—	—
	14 230	4 283	3 097	36 571

Assessment of credit risk *(continued)*

Residual contractual maturity of exposure – all portfolios

	30 June 2012				
	Exposure at default				
Residual contractual maturity of exposure[1]	Current to 6 months Rm	6 months to 1 year Rm	1 year to 5 years Rm	More than 5 years Rm	Total Rm
Banks	9 438	4 446	26 217	4 323	44 422
Corporate exposure	21 697	70 029	83 427	33 325	208 478
Corporate	18 583	56 985	70 894	19 614	166 076
SME Corporate	2 863	12 610	10 324	8 310	34 107
Specialised lending – income producing real estate	237	85	366	2 201	2 889
Specialised lending – project finance	14	349	1 843	3 200	5 406
Local governments and municipalities	41	4 309	1 748	4 006	10 103
Public sector entities	734	2 009	2 436	1 265	6 444
Retail	90 749	8 462	64 411	226 249	389 870
Mortgages (including home equity lines of credit)	37 692	2 124	6 895	213 937	260 648
Retail – other	6 896	2 536	53 621	6 212	69 265
Vehicle and asset finance	1 796	2 208	40 813	0	44 817
Unsecured lending <= 30 000	1 257	118	2 500	1 446	5 321
Unsecured lending > 30 000	3 843	210	10 308	4 766	19 127
Retail revolving credit	39 978	—	—	—	39 978
Credit cards	32 985	—	—	—	32 985
Non credit cards	6 993	—	—	—	6 993
SME Retail	6 183	3 802	3 895	6 100	19 980
Secured lending	89	187	2 937	5 297	8 510
Unsecured lending	6 094	3 615	958	803	11 470
Securities firms	946	98	95	267	1 406
Sovereign	43	67	65 778	702	66 589
	123 648	89 420	244 112	270 137	727 310

Note

[1]June 2012 disclosure is based on the revised regulatory requirements (Basel II.5) and will therefore only be comparable at the higher level asset classes of prior reporting periods.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Residual contractual maturity of exposure – all portfolios *(continued)*

	30 June 2011				
	Exposure at default				
Residual contractual maturity of exposure	Current to 6 months Rm	6 months to 1 year Rm	1 year to 5 years Rm	More than 5 years Rm	Total Rm
Banks	17 575	2 862	7 257	7 990	35 684
Corporate exposure	75 794	12 965	24 262	66 190	179 213
Corporate	66 033	12 000	22 942	44 578	145 553
SME Corporate	9 755	805	—	17 068	27 628
Specialised lending – income producing real estate	—	95	—	1 773	1 869
Specialised lending – project finance	6	65	1 320	2 771	4 163
Local governments and municipalities	2 278	1 075	1 204	3 293	7 851
Public sector entities	3 753	991	48	3 201	7 993
Retail	14 153	420	—	384 223	398 796
Mortgages	—	—	—	263 837	263 837
Retail – other	280	—	—	68 084	68 364
Retail revolving credit	9 266	—	—	36 109	45 375
SME Retail	4 607	420	—	16 193	21 220
Securities firms	150	43	458	77	727
Sovereign	184	113	20	549	866
	113 887	18 469	33 249	465 523	631 128
Standardised exposure					61 095
					692 224

Assessment of credit risk *(continued)*

Residual contractual maturity of exposure – all portfolios *(continued)*

	31 December 2011				
	Exposure at default				
Residual contractual maturity of exposure	Current to 6 months Rm	6 months to 1 year Rm	1 year to 5 years Rm	More than 5 years Rm	Total Rm
Banks	343	30	51 892	11 108	63 373
Corporate exposure	56 962	2 414	86 179	63 529	209 084
Corporate	42 923	2 414	77 571	45 613	168 521
SME Corporate	13 628	—	7 959	10 563	32 150
Specialised lending – income producing real estate	—	—	474	2 499	2 973
Specialised lending – project finance	411	—	175	4 854	5 440
Local governments and municipalities	3 475	—	929	5 103	9 507
Public sector entities	419	355	3 991	1 954	6 719
Retail	91 562	2 721	68 317	236 609	399 209
Mortgages	39 207	998	5 052	219 626	264 883
Retail – other	8 439	1 690	48 710	8 637	67 476
Retail revolving credit	36 215	—	10 236	—	46 451
SME Retail	7 701	33	4 319	8 346	20 399
Securities firms	—	40	1 003	300	1 343
Sovereign	55 830	—	3 290	918	60 038
	208 591	5 560	215 601	319 521	749 273

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements

The Group employs a number of techniques to mitigate credit risk, such as:

- Strengthening its position as a lender in a range of transactions, from retail mortgage lending to large wholesale financing, and by structuring a security interest in a physical or financial asset (collateral).
- Netting of debtor and creditor balances under regulatory and internal policy, which requires a formal agreement with the customer to net the balances and a legal right to set-off (on- and off-statement of financial position).
- Selective hedging through credit derivatives.

In certain circumstances, depending on the Group's assessment of a customer's financial capacity, financing may be granted on an unsecured basis.

Generally one or more forms of security are sought in the credit approval process. The use and approach to credit risk mitigation (CRM) varies by product type, portfolio, customer and business strategy. Minimum standards, as prescribed in the applicable policies and business processes, are applied across the Group and cover:

- General requirements including acceptable risk mitigation types, and any conditions or restrictions applicable to these mitigants.
- The maximum LTV ratios, minimum haircuts or other volatility adjustments applicable to each type of mitigant, including, where appropriate, adjustments for currency mismatch, obsolescence and any time sensitivities on asset values.
- The means by which legal certainty is to be established, including required documentation and necessary steps required to establish legal rights.
- Acceptable methodologies for initial and any subsequent valuations of collateral and the frequency with which they are to be revalued.
- Actions to be taken in the event of the current value of mitigation falling below required levels.
- Management of the risk of correlation between changes in the credit risk of the customer and the value of CRM, including for example, any situation where customer default materially impacts the value of a mitigant and applying a haircut or recovery value adjustment which reflects the potential correlation risk.
- Management of concentration risks, including setting thresholds and controls on the acceptability of credit risk mitigants and/or lines of business that are characterised by a specific collateral type or structure.
- Collateral management to ensure that CRM is legally effective and enforceable.

The Group's policies with regard to assessing, acquiring and managing collateral for capital calculation purposes are aligned with regulatory requirements.

The Banks Act and its regulations allow banks to adjust the risk-weighting of exposures by taking account of collateral. Eligibility for recognition in the calculation of RC depends on whether the bank is using the foundation or advanced IRB approach.

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements *(continued)*

Collateral types used by the Group, grouped by type of asset

The following types of collateral may be held against assets subject to credit risk and are consistent with accepted market practice:

Assets subject to credit risk	Type of collateral[1]
Cash, cash balances and balances with central banks Statutory liquid asset portfolio Loans and advances to banks Trading portfolio assets Hedging portfolio assets Other assets Loans and advances to customers Reinsurance assets Investment securities	**Guarantees, credit insurance and credit derivatives** Government guarantees Guarantees from shareholders and directors Parental guarantees Personal and other company guarantees Suretyships Bonds and guarantees **Physical collateral** Listed equities RSA government bonds Bonds over properties (commercial and residential) Charges on properties Property, equipment and vehicles Shares **Cash collateral** Deposits from customers and cession of ring-fenced bank accounts with cash Cash **Other** Call options to holding companies Cession of loan accounts Debentures Insurance policies Life insurance policies Listed equities Netting agreements Pledged securities Put options from holding companies or other companies within the Group Assignment of debtors

Note

[1]This list is not exhaustive. The Group may recognise other forms of collateral.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements *(continued)*

Valuation of collateral

Performing book

Security taken as part of the credit decision process is valued according to the applicable credit policies at the time of credit approval and at relevant intervals thereafter. The Group uses a number of approaches for the revaluation of collateral including physical inspection, statistical indexing and price volatility modelling.

Non-performing book

For the wholesale portfolio, collateral valuations are updated when an account enters the legal/recovery process to ensure an appropriate impairment allowance can be calculated. In the wholesale portfolios these valuations are reviewed regularly to ensure any impairments raised remain at an appropriate level, including potential gains in the valuation of marketable securities and other market-related instruments that may lead to a partial release of the impairment allowance. In the retail portfolio, collateral valuations are updated using statistical indexing which is available monthly.

The collateral management process is focused on the efficient handling and processing of a large number of cases in the retail portfolio and the lower end of the corporate sector, therefore relying heavily on the Group's collateral and document management systems. For larger wholesale exposures and capital market transactions, collateral is managed jointly between the credit and legal functions as transactions and associated legal agreements are often bespoke in nature, in particular where credit derivatives or customised netting agreements are used as a risk mitigant. All security structures and legal covenants are reviewed at least annually to ensure they remain fit for purpose and consistent with accepted market practice.

Types of guarantor and credit derivative counterparties

In the commercial, corporate and financial sector, the Group often places reliance on a third party guarantor which may be a parent company to the borrower, a major shareholder or a bank. Similarly, credit derivative transactions are often used to hedge specific parts of any single name risk in the wholesale portfolio. For these transactions, the most common counterparties or issuers are banks, non-bank financial institutions (NBFIs), large corporates, parastatals and governments. The creditworthiness of the guarantor or derivative counterparty/issuer is assessed as part of the credit approval process and the value of such a guarantee or derivative contract is adjusted accordingly for the purpose of calculating internal LGD estimates. For RC purposes, risk mitigants are incorporated in either EAD, PD or LGD, depending on the type of mitigant.

Use of netting agreements, International Swaps and Derivatives Association (ISDA) master agreements and collateral support annexes (CSAs)

In line with international market practice, the Group endeavours to use netting agreements wherever possible. The Group primarily employs ISDA master agreements as well as CSAs, which provide for standardised and commonly accepted processes for managing collateral and margin calls over the lifetime of the transaction. CSAs may create an obligation on the Group unrelated to the underlying instruments in the event of a credit downgrade. Only a small number of the Group's agreements make use of such a tiered structure and an instantaneous downgrade by one rating grade from the current AA-rating (Standard and Poor's and Fitch) would not trigger such clauses and create a requirement for the Group to post additional collateral.

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements *(continued)*

Credit risk mitigation in terms of regulatory disclosure requirements

Credit risk mitigation (CRM)

IRB approach	30 June 2012 Original credit and counterparty exposure Rm	30 June 2012 Effects of netting agreements Rm	30 June 2012 Net exposure after netting and credit risk Rm	30 June 2012 Eligible financial collateral Rm	30 June 2012 Other eligible IRB collateral Rm	30 June 2012 Credit risk mitigation affecting LGD estimates Rm	30 June 2011 Credit risk mitigation affecting LGD estimates Rm	31 December 2011 Credit risk mitigation affecting LGD estimates Rm
Banks	132 002	32 927	99 075	2 317	—	2 317	3 899	3 441
Corporate exposure	274 601	4 387	270 214	2 308	92 354	94 662	87 083	94 874
Corporate	228 919	4 387	224 532	2 308	66 550	68 858	65 859	69 773
SME corporate	34 827	—	34 827	—	21 999	21 999	18 685	20 882
Specialised lending – income producing real estate	4 161	—	4 161	—	3 805	3 805	2 539	4 219
Specialised lending – project finance[1]	6 694	0	6 694	—	—	—	—	—
Local government and municipalities	14 917	—	14 917	945	124	1 069	101	1 071
Public sector entities	18 436	717	17 719	561	246	807	1 680	712
Retail	440 077	—	440 077	—	591 138	591 138	613 690	622 214
– Mortgages (including home equity lines of credit)	294 611	—	294 611	—	516 359	516 359	543 840	542 896
– SME Retail	22 006	—	22 006	—	13 790	13 790	15 908	16 862
Secured lending[2]	9 286	—	9 286	—	11 975	11 975	n/a	n/a
Unsecured lending[2]	12 720	—	12 720	—	1 815	1 815	n/a	n/a
– Retail revolving credit	53 512	—	53 512	—	—	—	—	—
Credit cards[2]	47 802	—	47 802	—	—	—	n/a	n/a
Non credit cards[2]	5 710	—	5 710	—	—	—	n/a	n/a
– Retail – other	69 948	—	69 948	—	60 990	60 990	53 942	62 456
Vehicle and asset finance[2]	47 920	—	47 920	—	60 990	60 990	n/a	n/a
Unsecured lending[2] <= 30 000	4 889	—	4 889	—	—	—	n/a	n/a
Unsecured lending[2] > 30 000	17 139	—	17 139	—	—	—	n/a	n/a
Securities firms	23 270	269	23 000	589	—	589	334	501
Sovereign	63 003	85	62 918	415	6	422	487	444
Total	966 306	38 385	927 921	7 135	683 868	691 004	707 274	723 257

No CRM is taken into consideration for the SA.

Note

[1]Amounts indicated at zero reflect values less than a million.

[2]Basel II.5 reporting requirement, prior reporting periods comparatives not available.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements *(continued)*

Credit risk mitigation in terms of regulatory disclosure requirements *(continued)*

Counterparty credit risk

Counterparty credit exposure arises from the risk that parties are unable to meet their payment obligations under certain financial contracts, such as derivatives and securities financing transactions (e.g. repurchase agreements). Unlike credit risk, counterparty credit risk implies the bilateral risk of loss.

For allocation of EC to over-the-counter (OTC) derivative exposures, EAD estimates are treated as mark-to-market loan equivalents, where the amount of capital allocated to a particular transaction is driven by the:

- borrower's netting arrangements;
- borrower's TTC PD;
- trade's residual maturity;
- nature of each trade; and
- net EAD and corresponding LGD.

For RC calculation purposes, the current exposure method (CEM) is applied to OTC derivative exposures. The Group mainly relies on cash, government bonds and negotiable certificates of deposits (NCDs) as collateral for derivative contracts.

The Group intends to apply for permission to use the Internal Model Method (IMM) in the calculation of its RC requirements for these portfolios once the AIRB method for wholesale credit exposures has been embedded. However, during the reporting period, all calculations were based on the CEM. The Group's policies for establishing impairment allowances for traded products' counterparties are based on applicable accounting requirements.

Credit derivatives

The following table provides an overview of the outstanding amount of exposure held in respect of the Group's credit derivative positions, used in managing its credit portfolio, broken down by product type, indicating whether protection was bought or sold:

Exposure by instrument bought or sold

	30 June								31 December			
	2012				2011				2011			
	Intermediation portfolio				Intermediation portfolio				Intermediation portfolio			
	As protection buyer		As protection seller		As protection buyer		As protection seller		As protection buyer		As protection seller	
	Banking Rm	Trading Rm	Banking Rm	Trading Rm	Banking Rm	Trading Rm	Banking Rm	Trading Rm	Banking Rm	Trading Rm	Banking Rm	Trading Rm
Credit derivative product type												
Credit-default swaps	—	7 153	—	11 289	—	4 509	—	7 269	—	6 987	—	10 494
Other	8 845	—	699	—	10 801	—	577	—	8 813	—	690	—
Total notional exposure to credit derivative transactions	8 845	7 153	699	11 289	10 801	4 509	577	7 269	8 813	6 987	690	10 494

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements *(continued)*

Credit risk mitigation in terms of regulatory disclosure requirements *(continued)*

Credit derivatives *(continued)*

Breakdown of OTC and credit derivative exposure

This book is volatile and derivative exposure are driven by mark-to-market due to changes in the underlying instrument during the reporting period.

	30 June 2012							
	Gross positive fair value Rm	Current netting benefits Rm	Current exposure Rm	Expected positive exposure (CEM) Rm	Expected positive exposure netting (CEM) Rm	Exposure at default Rm	Collateral value Rm	Notional value Rm
Commodities	460	378	82	843	127	668	—	8 070
Credit derivatives	111	102	9	1 377	658	730	—	17 700
Equity derivatives	1 328	800	528	1 746	682	1 380	—	28 517
Foreign exchange derivatives	12 635	10 705	1 930	14 019	7 254	8 517	—	700 187
Interest rate derivatives	32 187	26 922	5 265	10 065	5 280	10 034	—	2 883 524
	46 721	38 907	7 814	28 050	14 001	21 329	—	3 637 998

	30 June 2011							
	Gross positive fair value Rm	Current netting benefits Rm	Current exposure Rm	Expected positive exposure (CEM) Rm	Expected positive exposure netting (CEM) Rm	Exposure at default Rm	Collateral value Rm	Notional value Rm
Commodities	229	151	78	215	52	241	—	3 693
Credit derivatives	106	87	19	1 023	407	634	—	13 191
Equity derivatives	525	315	210	2 015	1 052	1 173	—	32 068
Foreign exchange derivatives	12 703	8 533	4 170	11 724	5 438	10 456	—	572 212
Interest rate derivatives	23 214	18 478	4 736	10 505	5 413	9 829	—	3 644 116
	36 777	27 564	9 213	25 482	12 362	22 333	—	4 265 280

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Credit risk mitigation, collateral and other credit enhancements *(continued)*

Credit risk mitigation in terms of regulatory disclosure requirements *(continued)*

Credit derivatives *(continued)*

Breakdown of OTC and credit derivative exposure *(continued)*

	31 December 2011							
	Gross positive fair value Rm	Current netting benefits Rm	Current exposure Rm	Expected positive exposure (CEM) Rm	Expected positive exposure netting (CEM) Rm	Exposure at default Rm	Collateral value Rm	Notional value Rm
Commodities	267	171	96	172	46	222	—	1 657
Credit derivatives	151	144	7	1 394	687	714	—	17 883
Equity derivatives	1 190	744	446	2 338	960	1 824	—	37 145
Foreign exchange derivatives	20 620	17 045	3 575	14 054	7 384	10 245	—	695 789
Interest rate derivatives	30 944	26 433	4 511	12 322	6 660	10 173	—	4 006 935
	53 172	44 537	8 635	30 280	15 737	23 178	—	4 759 409

Credit rating downgrade

The Group enters into derivative contracts with rated and unrated counterparties. To mitigate counterparty credit risk, the Group stipulates credit protection terms such as limitations on the amount of unsecured credit exposure it will accept, collateralisation in the event of a mark-to-market credit exposure exceeding the current amount and collateralisation and/or termination of a contract when certain credit events occur. Such events might include a downgrade of the counterparty's public credit rating.

Certain counterparties may require the Group to provide similar credit protection terms, to which it may agree from time to time on a restrictive basis. Rating downgrades as a collateralisation or termination event are generally only conceded to highly rated counterparties, and whenever possible, on a reciprocal basis.

The impact on the Group in terms of the additional amount of collateral required in the event of a credit downgrade is determined by the negative mark-to-market value on derivative contracts. Where the impact on the Group's liquidity is deemed to be material, the potential exposure is taken into account in model stress testing. Generally, the extent of legal commitments resulting in additional collateral requirements caused by a rating downgrade is not material and would not adversely affect the Group's financial position.

As at the reporting date, no additional collateral would have been required for a one- or two-notch downgrade. An additional R45 million would have been required to be posted for a three-notch downgrade.

Assessment of credit risk *(continued)*

Impairments: relevant accounting impairment policy versus expected loss regulatory policy

International Financial Reporting Standards (IFRS) govern reporting practices of banks and, in part, overlap with the requirements of regulation 43 of the Banks Act (commonly known as Pillar 3). IFRS 7 *Financial Instruments: Disclosures* (IFRS 7) prescribes disclosure requirements pertaining to financial instruments for accounting purposes and, as such, is based on a similar set of data used for Pillar 3 reporting purposes. Regulation 43 requires banks to disclose certain accounting definitions and information, in particular, with respect to impairments, past due loans and advances and charge-offs. The Group regularly reconciles the data used for both financial (IFRS) and regulatory (Pillar 3) disclosures.

Impairment methods of assessment and use of allowance accounts

The Group establishes, through charges against profit, an impairment allowance for the incurred loss inherent in the lending book. Under IFRS, impairment allowances are recognised where there is objective evidence of impairment as a result of one or more loss events that have occurred after initial recognition of the asset, and where these events had an impact on the estimated future cash flows of the financial asset or portfolio of financial assets. To determine if a loss event has occurred, historical economic information similar to the current economic climate, overall customer risk profile, payment record and the realisable value of any collateral, are taken into consideration.

Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Group, which may include the following loss events:

- significant financial difficulty experienced by the issuer or borrower;
- a breach of contract, such as a default or delinquency in interest and/or principal payments;
- the Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a concession that the lender would not otherwise consider, such as restructuring;
- it becomes probable that the borrower will enter insolvency or other financial reorganisation proceedings;
- the disappearance of an active market for a financial asset as a result of financial difficulties;
- observable data indicating a measurable decrease in the estimated future cash flows from a group of financial assets following the initial recognition of those assets, although the decrease cannot yet be identified with individual financial assets in the group, including:
  - adverse changes in the payment status of borrowers in the group; or
  - national or local economic conditions that correlate with defaults on the assets in the group.

Impairments in respect of assets which are individually significant or which have been flagged as being in default, are measured individually. Where a portfolio comprises homogeneous assets and appropriate statistical techniques are available, it is measured collectively. The amount of loss is measured as the difference between the asset carrying amount and the present value of estimated future cash flows (excluding future credit losses), discounted at the financial asset's original effective interest rate. Two key aspects in the cash flow calculation are the valuation of all security and the timing of all asset realisations, after allowing for all collection and recovery costs.

For the purposes of a collective evaluation of impairment, financial assets are allocated to groups, based on similar risk characteristics, asset type, industry, geographical location, collateral type, past due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for such groups of assets, being indicative of the counterparty's ability to pay amounts due under the contractual terms of the assets.

Assessment of credit risk *(continued)*

Impairments: relevant accounting impairment policy versus expected loss regulatory policy *(continued)*

Impairment methods of assessment and use of allowance accounts (continued)

Unidentified impairment allowances are raised when observable data indicates a measurable decrease in the estimated future cash flows from a group of financial assets since their original recognition, even though the decrease cannot yet be linked to individual assets in the group. The unidentified impairment calculation is based on the asset's probability of moving from the performing portfolio to the defaulted portfolio as a result of a risk condition which has already occurred, but will only be identifiable at a borrower level at a future date.

An emergence period concept is applied to ensure that only impairments that exist at the reporting date are captured. The emergence period is defined as the time lapse between the occurrence of a trigger event (unidentified impairment) and the impairment being identified at an individual account level (identified impairment). The emergence periods, based on actual experience, vary across businesses and are reviewed annually. The PD for each exposure class is based on historical default experience, scaled for the emergence period relevant to the exposure class. This PD is then applied to all exposures in respect of which no identified impairments have been recognised. Where total EL of all credit risk assets exceeds total impairments, the difference is deducted from eligible capital. In the instance that total impairments exceed total EL, the difference is added to eligible capital, subject to a maximum of 0,6% of total RWAs.

The impairment allowance also takes into account the expected severity of loss at default, or the LGD, which is the amount outstanding that is written off and is therefore not recoverable.

Recovery varies by product and depends, for example, on the level of security held in relation to each loan as well as the Group's position relative to other claimants. The LGD estimates are based on historical loss experience. Historical loss experience data is adjusted to add current economic conditions into the data set, which conditions did not exist at the time of loss experience and/or to remove the effects of conditions in the historical period that do not currently exist.

The replacement of *International Accounting Standards (IAS) IAS 39 Financial instruments: Recognition and Measurement (IAS 39)* with IFRS 9 Financial Instruments (IFRS 9) will have a significant impact on banks' financial statements, the biggest impact being the calculation of impairments. IFRS 9 will replace the current incurred loss model with the requirement to calculate expected losses. Final agreement has not been reached on the exact approach to be followed. It is expected that the new rules will be mandatory from January 2015, with comparative numbers for 2014 to be published at the same time.

Identified impairments on financial assets

According to the Group's credit policy, the following are key indicators of default:

- the borrower is unlikely to pay its credit obligation in full, without recourse by the Group to actions such as realising security held; and/or
- the borrower is overdue.

In the wholesale portfolio, the identified impairment is calculated on accounts reflected on management EWLs (category 3), and accounts currently going through the legal process. Identified impairments are raised on an individual basis and constitute the difference between the outstanding capital and the present value of future cash flows.

Retail identified impairment is triggered when a contractual payment is missed. The impairment calculation is based on a roll-rate approach, where the percentage of assets moving from the initial delinquency state to default is derived from statistical probabilities, based on experience. The PD is calculated within a certain outcome period. The outcome period is defined as the timeframe within which assets default. Recovery amounts and contractual interest rates are calculated using a weighted average for the relevant portfolio.

Future cash flows for a group of financial assets which are collectively evaluated for impairment purposes are estimated based on the contractual cash flows of the assets within the group and the historical loss experienced for assets with similar credit risk characteristics to those in the group.

In the retail portfolio, the identified impairment is calculated on a collective basis. For accounting purposes, these accounts are considered to be identified impairments.

Write-offs

Once an advance has been identified as impaired and an impairment allowance has been raised, circumstances may change and indicate that the prospect of further recovery does not exist. Write-offs will occur when, and to the extent that, the debt is considered irrecoverable.

The timing and extent of write-offs is driven by a write-off policy based on an age-driven concept. A write-off can also be triggered by a specific event, such as the conclusion of insolvency proceedings or other formal recovery actions which makes it possible to quantify the extent of the advance which is beyond a realistic prospect of recovery. Nonetheless, impaired loans are reviewed at least quarterly, ensuring irrecoverable advances are written off in a timely and systematic way and in compliance with local regulations.

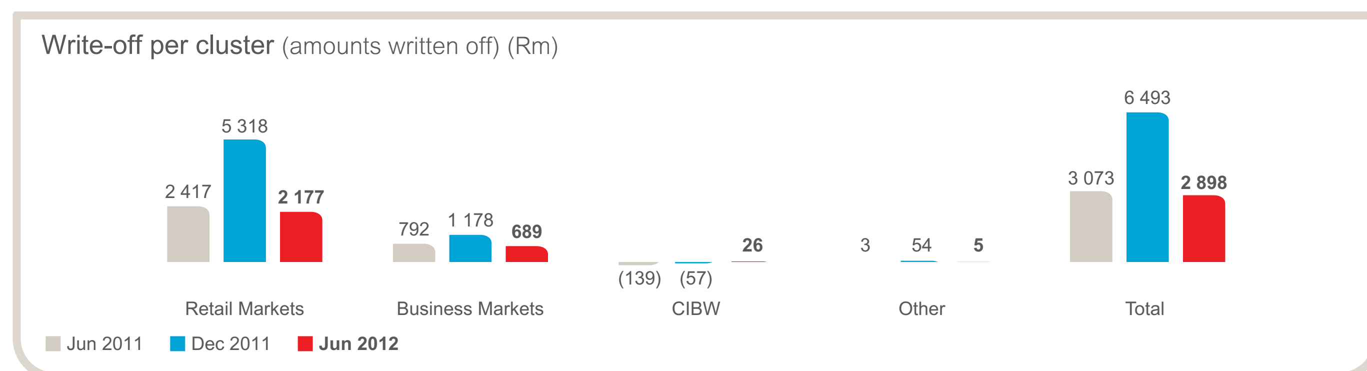
Assets are only written off once all necessary procedures have been completed and the amount of loss has been determined. Recoveries of amounts previously written off are reversed and accordingly decrease the amount of the reported loan impairment charge in the statement of comprehensive income.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Impairments: relevant accounting impairment policy versus expected loss regulatory policy *(continued)*

Write-offs (continued)



Net present value unwind on non-performing book

The impairment allowance contains a net present value adjustment that represents the time value of money of expected cash flows. Such time value of money reduces as the point of cash flow is approached. The time based reduction in time value of money is recognised in the statement of comprehensive income as interest received on impaired assets.

Reconciliation of total impairments (identified and unidentified)

30 June 2012

Impairment of loans and advances to customers	Opening balance Rm	Net present value unwind on non-performing book Rm	Exchange differences Rm	Amounts written off Rm	Impairment raised identified Rm	Impairment raised unidentified Rm	Closing balance Rm
Retail Markets	9 061	(504)	—	(2 178)	3 508	(52)	9 835
Business Markets	2 379	(43)	—	(689)	787	(6)	2 428
CIBW	566	(2)	3	(26)	14	(4)	551
Other	125	1	—	(5)	94	0	215
	12 131	(548)	3	(2 898)	4 403	(62)	13 029

30 June 2011[1]

Impairment of loans and advances to customers	Opening balance Rm	Net present value unwind on non-performing book Rm	Exchange differences Rm	Amounts written off Rm	Impairment raised identified Rm	Impairment raised unidentified Rm	Closing balance Rm
Retail Markets	10 789	(519)	—	(2 417)	2 680	(45)	10 488
Business Markets	2 642	(70)	6	(792)	603	(4)	2 385
CIBW	471	(3)	—	139	26	(4)	629
Other	—	3	—	(3)	—	—	—
	13 902	(589)	6	(3 073)	3 309	(53)	13 502

Note
[1]Comparatives have been reclassified to align with the Group's segment changes in the reporting period. See overview for details.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Impairments: relevant accounting impairment policy versus expected loss regulatory policy *(continued)*

Net present value unwind on non-performing book (continued)

	31 December 2011[1]						
Impairment of loans and advances to customers	Opening balance Rm	Net present value unwind on non-performing book Rm	Exchange differences Rm	Amounts written off Rm	Impairment raised identified Rm	Impairment raised unidentified Rm	Closing balance Rm
Retail Markets	10 789	(1 048)	—	(5 318)	4 649	(11)	9 061
Business Markets	2 642	(125)	—	(1 178)	1 096	(55)	2 380
CIBW	471	(5)	1	57	96	(55)	565
Other	—	5	—	(54)	174	—	125
	13 902	(1 173)	1	(6 493)	6 015	(121)	12 131

Concentration of credit risk

A concentration of credit risk exists when a number of counterparties are located in a geographical region, and/or are engaged in similar activities and/or have similar economic characteristics such that their ability to meet contractual obligations is similarly affected by changes in economic or other conditions. The analyses of credit risk concentrations presented below are based on the location of the counterparty or customer or the industry in which they are engaged.

Measuring exposures and concentrations

Loans and advances to customers provide the principal source of credit risk to the Group although it can also be exposed to other forms of credit risk through, for example, loans to banks, loan commitments and debt securities. Group risk management policies and processes identify and analyse risk, set appropriate risk appetite limits and controls and monitor the risks and adherence to limits by means of reliable and timely data. One particular area of review is concentration risk.

Diversification is achieved through setting maximum exposure guidelines to individual counterparties. Excesses are reported to the Group Exco Risk-type Committees and the GRCMC. Mandate and scale limits are used to limit the stock of current exposures in a loan portfolio and the flow of new exposures into a loan portfolio. Limits are typically based on the nature of the lending and the amount of the portfolio meeting certain standards of underwriting criteria.

Due to the composition of the Group's business portfolios, a certain degree of risk concentration in the collateral portfolios is evident. The Group manages these risks through mandate and scale limits that differ across the individual portfolios, for example:

- vehicle and asset finance: limits are placed on the tenure of loans;
- mortgages: limits are placed on property values and LTV ratios; and
- commercial property finance: limits are placed on the type of asset (e.g. industrial or retail) and geographical area.

Due to the structure of the South African financial markets, a certain level of concentration with derivative counterparties is also to be expected. The Group manages this type of concentration risk through mandate and scale limits, sophisticated, simulation-based exposure models that support a rigorous credit analysis, ongoing monitoring of these counterparties and the Group's mark-to-market (MTM) exposure.

Note

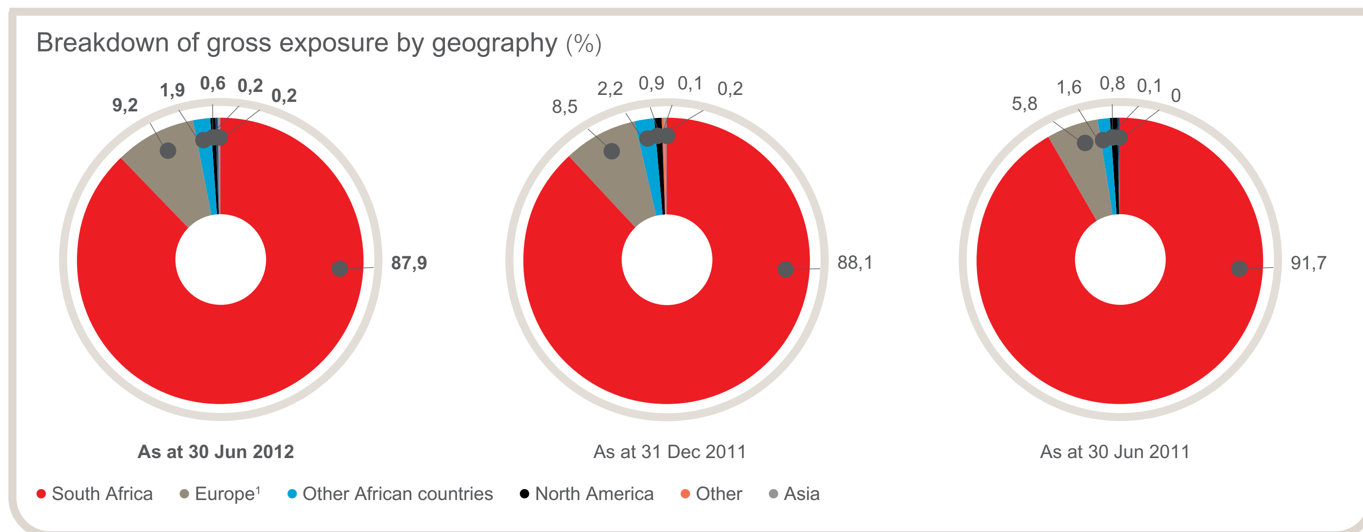
[1]Comparatives have been reclassified to align with the Group's segment changes in the current reporting period. See overview for details.

Retail and wholesale credit risk

Assessment of credit risk *(continued)*

Concentrations of credit risk *(continued)*

Breakdown of gross exposure by geographical area



30 June 2012	South Africa Rm	Europe[1] Rm	Other African countries Rm	North America Rm	Other Rm	Asia Rm	South America Rm	Total Rm
Standardised		—	12 946	—	—	—	—	12 946
Internal Ratings Based	860 321	90 376	5 671	5 692	1 920	2 323	1	966 304
FIRB	—	—	—	—	—	—	—	—
AIRB	860 321	90 376	5 671	5 692	1 920	2 323	1	966 304
Total	860 321	90 376	18 617	5 692	1 920	2 323	1	979 250

30 June 2011	South Africa Rm	Europe[1] Rm	Other African countries Rm	North America Rm	Other Rm	Asia Rm	South America Rm	Total Rm
Standardised	50 999	—	10 096	—	—	—	—	61 095
Internal Ratings Based	764 236	51 109	4 356	7 021	1 141	482	—	828 346
FIRB	312 402	51 109	4 356	7 021	1 141	482	—	376 512
AIRB	451 834	—	—	—	—	—	—	451 834
Total	815 235	51 109	14 452	7 021	1 141	482	—	889 441

Note

[1]The majority of the exposures reflecting under Europe relate to exposures to Barclays Bank Plc.

Retail and wholesale credit risk

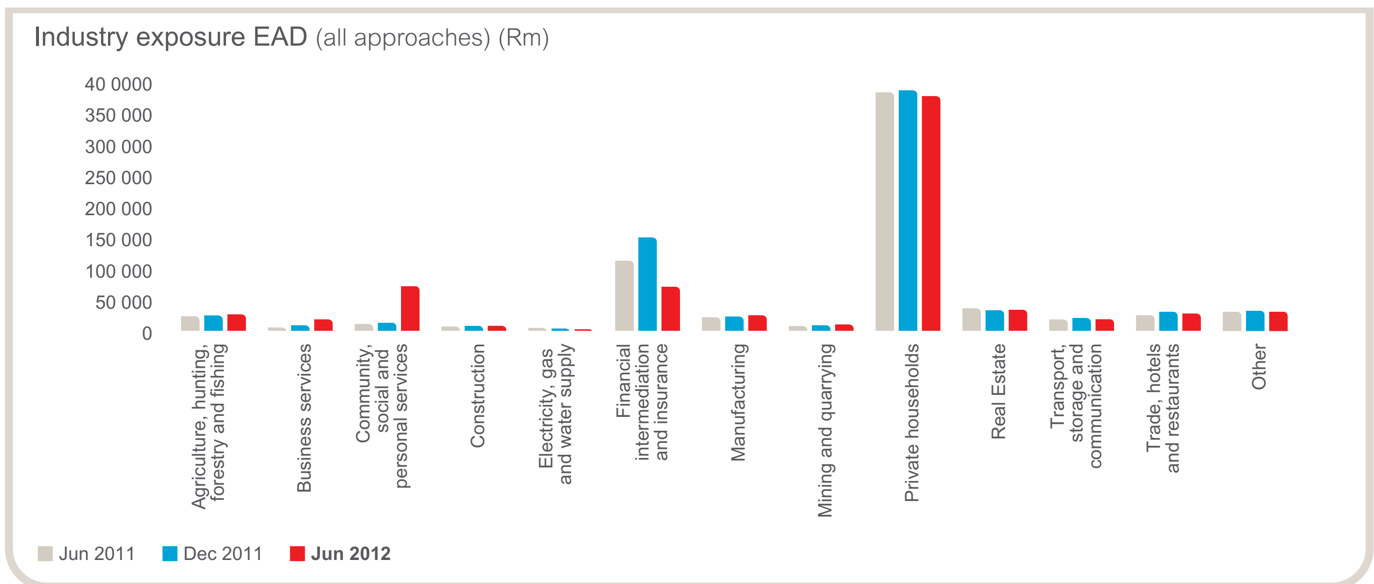
Assessment of credit risk *(continued)*

Concentrations of credit risk *(continued)*

Breakdown of gross exposure by geographical area (continued)

	31 December 2011							
	South Africa Rm	Europe[1] Rm	Other African countries Rm	North America Rm	Other Rm	Asia Rm	South America Rm	Total Rm
Standardised	55 831	—	14 345	—	—	—	—	70 176
Internal Ratings Based	784 224	80 629	6 366	8 260	1 298	2 081	1	882 859
FIRB	340 807	80 629	6 366	8 260	1 298	2 081	1	439 442
AIRB	443 417	—	—	—	—	—	—	443 417
Total	840 055	80 629	20 711	8 260	1 298	2 081	1	953 035

Breakdown of exposure per industry



Wrong-way risk

Wrong-way risk is another form of concentration risk and arises when there is a strong correlation between the counterparty's PD and the MTM value of the underlying transaction. The Group distinguishes between two types of wrong-way risk, namely:

- Specific wrong-way risk, which may arise in transactions with certain structural features such as the collateralisation of a loan with the borrower or a related party's shares.
- General or conjectural wrong-way risk, which may arise where the credit quality of the counterparty is related to the value of the transaction for non-specific reasons such as where both the credit quality of the counterparty and the value of the derivative are strongly related to a macroeconomic variable.

The Group aims to limit both these risk types. However, it recognises the need to engage in certain transactions which could expose it to specific wrong-way risk such as funding broad-based black economic empowerment (BBBEE) transactions.

Note

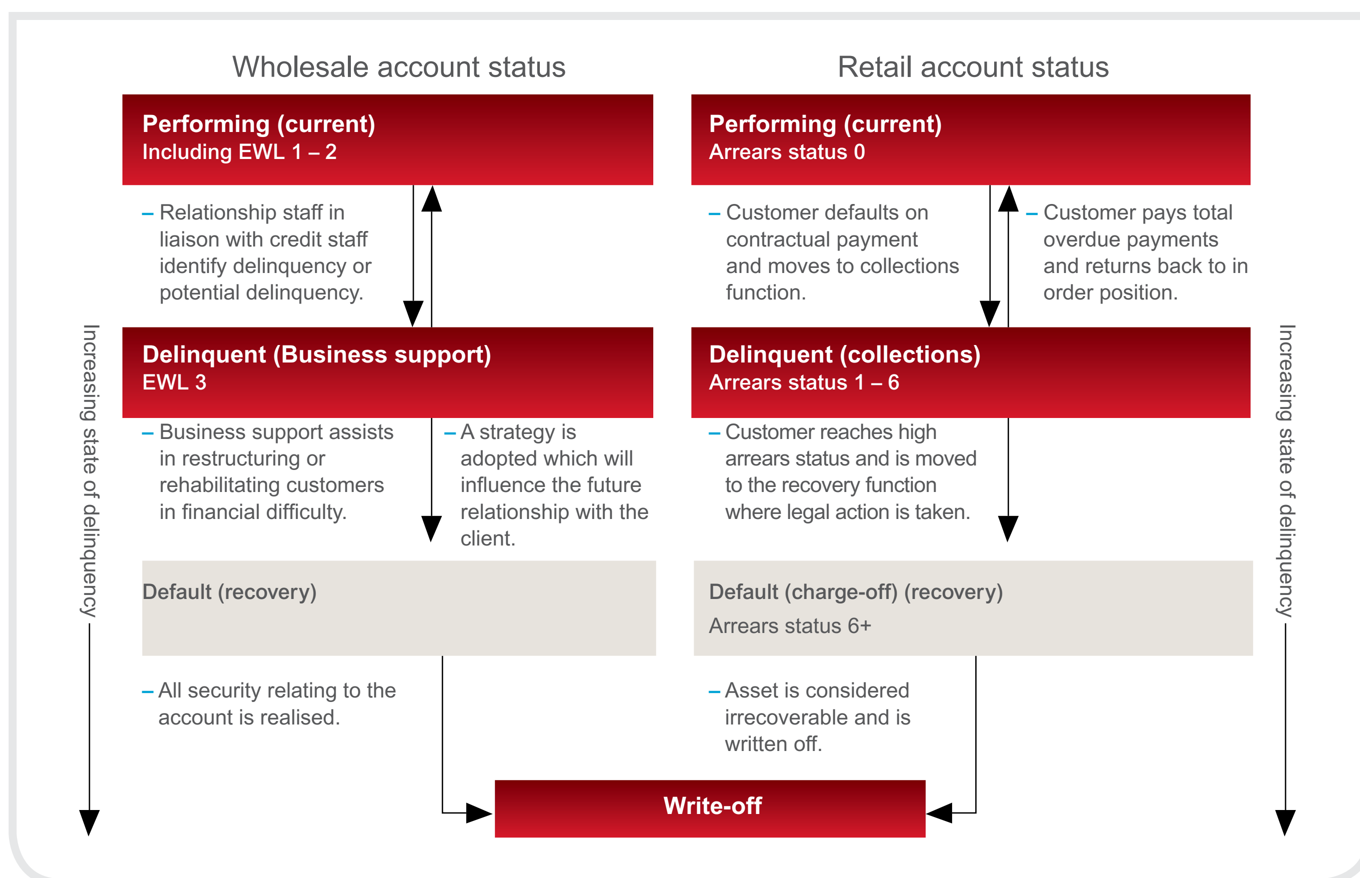
[1]The majority of the exposures reflecting under Europe relates to Barclays Bank Plc.

Assessment of credit risk *(continued)*

Monitoring weaknesses in portfolios

Corporate accounts which are deemed to contain heightened levels of risk are recorded on EWLs. These are updated monthly and circulated to relevant risk control points. Once an account is included on an EWL, exposure is carefully monitored and, where possible, a reduction of the exposure is effected. The lists are graded in line with the perceived severity of the risk attached to the loan. Corporate customers are escalated through three categories of increasing concern. When an account becomes impaired it would normally, but not necessarily, have passed through all three categories, which reflects the need for increased monitoring and control. Where a borrower's financial health presents grounds for concern it is immediately placed into the appropriate category. All borrowers are subject to a full review of all facilities on at least an annual basis. Interim reviews may be performed if necessary.

Within the Retail Banking portfolios which tend to comprise homogeneous assets, statistical techniques allow impairment to be monitored on a portfolio basis. It is consistent with Group policy to raise an impairment allowance as soon as objective evidence of impairment is identified as a result of one or more loss events that occurred, subsequent to initial recognition. Models in use are based upon customers' personal and financial performance information over recent periods, which serve as a predictor for future performance. The models' output are regularly reviewed against actual performance and, where necessary, amended to optimise their effectiveness.



Securitisation

Securitisation transactions used as part of the Group's credit portfolio are primarily focused on the effective management of funding requirements. Planned securitisation transactions, market appetite and potential marketing and placement strategies are governed by a delegated mandate from the Board Finance Committee (BFC) and assessed with the assistance of the MRC and ALCO. There are two main types of securitisation:

- traditional securitisation transactions where an originating bank transfers a pool of assets it owns to a Special Purpose Entity on an arm's length basis; and
- synthetic securitisation transactions where the originating bank transfers only the credit risk associated with an underlying pool of assets through the use of credit-linked notes or credit derivatives, while retaining legal ownership of the pool of assets.

All securitisation transactions entered into as at the reporting date involved the sale of the underlying assets to the securitisation vehicle. The Group has not originated any synthetic securitisation transactions. Nonetheless, the Group calculates appropriate capital charges in respect of the risk assumed through the provision of liquidity facilities and retained exposures, as per the Basel II.5 securitisation framework.

As at the reporting date, the Group has securitised its own assets relating to the Home loan portfolio. For the Homes securitisation, we apply the look through approach hence transfer of credit risk does not take place. In addition to credit risk, liquidity and interest rate risk are also considered regularly. The origination of transactions based on other asset classes, such as commercial property finance (CPF) are considered on an ongoing basis.

The Group intends to securitise R775 million mortgage advances in the banking book, within the six-month period following the reporting date.

The Group does not enter into any resecuritisation transactions.

Securitisation activities of the Group

Securitisation transactions have been used as a means of raising long-term funding. The Group applies the IRB approach in the assessment of its securitisation exposures for RC purposes and uses Fitch, Moody's and Standard and Poor's as external credit assessment institutions (ECAIs).

Apart from originating and sponsoring securitisation transactions, the Group also acts as an investor, a service provider, a liquidity provider and credit enhancer to a number of securitisation transactions. Absa invests directly in the securitisation schemes.

The following table provides a breakdown of the Group's role in each transaction during 2012:

Roles played by the Group in securitisation schemes	Originator	Sponsor	Investor (Absa)	Liquidity provider	Services provider	Credit enhancement/ subordinated loan
Blue Granite 1 Proprietary Limited			√			
Grayston Conduit Proprietary Limited				√		
Home Obligors Mortgage Enhanced Securities Proprietary Limited	√	√	√		√	√
Nitro 4				√		
Nqaba Finance Proprietary Limited				√		
On the Cards Investment II			√			
Prime Realty Obligors Packaged Securities Proprietary Limited				√		
Thekweni Fund 7 Proprietary Limited			√			

The following facilities have been cancelled in the reporting period:

- Vukile Investment Property Securitisation Proprietary Limited;
- Ikhaya RMBS 2 Limited; and
- Blue Granite 4 Proprietary Limited

Securitisation

Summary of applicable accounting policies

At the start of a securitisation transaction, assets are sold to the securitisation vehicle at par value and no gains or losses are recognised. The transactions are treated as sales (rather than financing) and for financial reporting purposes the respective vehicles are consolidated at a Group level.

Any retained interest in the securitisation vehicle is valued on the basis of the respective asset's performance. Key valuation assumptions for retained interests of this nature will include spreads to discount rates, default and recovery rates and prepayment rates that may be observable or unobservable. Where the Group acts as a service provider, normal impairment policies are applied and retained tranches are ultimately written off once sufficient capital losses accumulate.

Securitisation exposures

The following table provides a breakdown of the total funding raised through securitisation at the reporting date as well as the ECAIs used in the various asset classes.

Portfolio securitised

	30 June				31 December	
	2012		2011		2011	
	Amount securitised Rm	**ECAI Rm**	Amount securitised Rm	ECAI Rm	Amount securitised Rm	ECAI Rm
Mortgage advances	**5 057**	**Moody's, Fitch, Standard and Poor's**	5 057	Moody's, Fitch, Standard and Poor's	5 057	Moody's, Fitch, Standard and Poor's

Mortgage advances remained consistent during the reporting period.

No securitised assets existed at the reporting date which related to instalment finance.

The Group originated securitisation transactions performed according to expectations and no triggers were breached.

Outstanding securitisation balances

	30 June						31 December		
	2012			2011			2011		
IRB exposure	**Retail: mortgages Rm**	**Retail: other[1] Rm**	**Total Rm**	Retail: mortgages Rm	Retail: other[1] Rm	Total Rm	Retail: mortgages Rm	Retail: other[1] Rm	Total Rm
On-statement of financial position	**4 913**	**—**	**4 913**	4 682	2 317	6 999	4 958	—	4 958
Off-statement of financial position	**—**	**—**	**—**	—	—	—	—	—	—
Total IRB exposures	**4 913**	**—**	**4 913**	4 682	2 317	6 999	4 958	—	4 958
Of which notes issued									
Investment grade	**4 019**	**—**	**4 019**	4 019	2 317	6 336	4 019	—	4 019
Sub-investment grade[2]	**1 038**	**—**	**1 038**	1 038	—	1 038	1 038	—	1 038

Notes

[1]Retail: Other represents Abacas (the Group is sponsor) being a conduit (asset backed commercial paper programme). This book has been wound up in December 2011.

[2]Sub-investment grade – BBB and below.

Securitisation *(continued)*

Securitisation exposures *(continued)*

Outstanding securitisation balances (continued)

Past due securitisation exposures

	30 June						31 December		
	2012			2011			2011		
Originator	**Amount securitised Rm**	**Past due Rm**	**Recognised losses Rm**	Amount securitised Rm	Past due Rm	Recognised losses Rm	Amount securitised Rm	Past due – originator Rm	Recognised losses Rm
Mortgage advances	**5 057**	**7**	**—**	5 057	56	—	5,057	69	—

Retained or purchased securitisation exposures per asset class

	30 June						31 December		
	2012			2011			2011		
Exposure type	**Retained Rm**	**Purchased Rm**	**Total Rm**	Retained Rm	Purchased Rm	Total Rm	Retained Rm	Purchased Rm	Total Rm
Corporate/Sovereign/Banks	**—**	**—**	**—**	135	—	135	—	—	—
Residential mortgages	**946**	**468**	**1 414**	946	824	1 770	946	1 100	2 046
Retail – other	**—**	**368**	**368**	—	717	717	—	368	368
Small- and medium-sized entity	**—**	**—**	**—**	—	226	226	—	150	150
Total	**946**	**836**	**1 782**	1 081	1 767	2 848	946	1 618	2 564

Retained or purchased securitisation exposure by risk weight band

	30 June				31 December	
	2012		2011		2011	
Risk-weight band (%)	**Retained Rm**	**Purchased Rm**	Retained Rm	Purchased Rm	Retained Rm	Purchased Rm
7 – 10	**—**	**—**	—	—	—	—
11 – 19	**—**	**368**	135	638	—	437
20 – 49	**—**	**468**	—	1 074	—	1 126
50 – 75	**—**	**—**	—	—	—	—
76 – 99	**—**	**—**	—	—	—	—
100	**—**	**—**	—	55	—	55
250	**23**	**—**	23	—	23	—
350	**—**	**—**	—	—	—	—
425	**—**	**—**	—	—	—	—
650	**—**	**—**	—	—	—	—
1 250 or deducted	**923**	**—**	923	—	923	—
Total	**946**	**836**	1 081	1 767	946	1 618

Securitisation *(continued)*

Securitisation exposures *(continued)*

Rated securitised exposures in terms of IRB approach

(Excluding deductions and investors interest in respect of schemes with early amortisation features)

	30 June								31 December			
	2012				2011				2011			
IRB exposures	Total senior exposure rated BBB or better Rm	Total base risk weight exposure rated BBB or better Rm	Total exposure rated BBB or below Rm	Total Rm	Total senior exposure rated BBB or better Rm	Total base risk weight exposure rated BBB or better Rm	Total exposure rated BBB or below Rm	Total Rm	Total senior exposure rated BBB or better Rm	Total base risk weight exposure rated BBB or better Rm	Total exposure rated BBB or below Rm	Total Rm
SME[1] receivables	—	—	—	—	1	3	—	4	—	2	5	7
Retail: mortgages	37	74	—	111	37	100	8	145	35	108	—	143
Retail: instalments sales and leasing	2	—	—	2	1	12	5	18	3	—	—	3
Retail: other	9	7	—	16	8	76	—	84	8	6	—	14
Total	48	81	—	129	47	191	13	251	46	116	5	167

RWAs and capital deductions (IRB)

	30 June				31 December	
	2012		2011		2011	
IRB exposures	RWAs Rm	Required capital[1] Rm	RWAs Rm	Required capital[1] Rm	RWAs Rm	Required capital[1] Rm
SME receivables	—	—	45	4	75	7
Retail: mortgages	1 138	108	1 475	140	1 467	139
Retail: instalment sales and leasing	21	2	188	18	29	3
Retail: other	157	15	863	82	145	14
	1 316	125	2 571	244	1 716	163

Note

[1]Required capital is calculated at 9,5%. This excludes the Group specific (Pillar 2b) add-on.

Equity investment risk

Approach to equity investment risk

Equity investment risk refers to the risk of adverse changes in the value of listed and unlisted equity investments. These investments are longer-term investments held in the banking book for non-trading purposes.

The Group's equity investment risk objective is to balance the portfolio composition in line with the Group's risk appetite, with selective exits as appropriate.

The Group's governance of equity investments is based on the following key fundamental principles:

- a formal approval governance process;
- key functional specialists reviewing investment proposals;
- adequate monitoring and control after the investment decision has been implemented; and
- ongoing implementation of best practice standards based on current market trends, hurdle rates and benchmarks.

Criteria considered for new investments and investment reviews cover a comprehensive set of financial, commercial, legal (and technical, where required) matters. The performance of these investments is monitored relative to the objectives of the portfolio.

The majority of the Group's equity investments are held in CIBW and BM. Equity and other investments held by insurance entities of the Group are addressed in the insurance risk management section of this report.

Relevant accounting policies

IAS 39 requires all equity investments to be fair valued. Accounting policies relating to subsidiaries and investments in associates and joint ventures are discussed separately in note 1.3 of the Group's annual financial statements.

The fair value of equity investments is determined using appropriate valuation methodologies which, depending on the nature of the investment, include discounted cash flow analysis, enterprise value comparisons with similar companies and price-earnings comparisons.

Listed and unlisted investments are either designated at fair value through profit or loss or as available-for-sale. Investments in entities that form part of the venture capital and similar activities of the Group have been designated at fair value through profit or loss. The designation has been made in accordance with *IAS 39: Financial instruments: Recognition and measurement*, based on the scope exclusion that is provided in *IAS 28: Investments in Associates* and *IAS 31: Interests in Joint Ventures*. Interests in Joint Ventures (IAS 31). The relevant accounting policies for equity investments are discussed in note 1.7 of the Group's annual financial statements.

Approach to equity investment risk *(continued)*

Risk measurement

Equity investment risk is monitored monthly in terms of regulatory and EC requirements and is complemented by a range of additional risk metrics and stress testing. The equity investment risk profile is further tracked across a range of dimensions such as geography, industry and currency. Risk monitoring is done in accordance with a risk appetite, mandate and scale limits framework.

The Group has adopted the market-based simple risk weight approach to calculate RWAs and RC for equity risk in the banking book. According to this approach, RWAs are calculated using weightings of 300% and 400% for listed and unlisted equity investments respectively. Amended Basel regulations effective January 2012 prescribe a scaling factor of 1.06. Consequently, RWAs are calculated using weightings of 318% and 424% for listed and unlisted equity investments respectively. RC requirements in respect of investments in associates and joint ventures, defined as financial companies in the regulations relating to banks, are calculated with reference to either the pro rata consolidation methodology or the deduction approach.

EC for equity investment risk in the banking book is based on investment type and portfolio risk modelling and varies from 35,2% to 100%.

Analysis of equity investment risk in the banking book (regulatory definition)

The equity portfolio falling within the ambit of the Regulation 31 of the Regulations to the Banks, excludes third-party equity investments under management for which the Group does not bear the risk, selected associates treated under the pro rata consolidation methodology, and equity investments held by insurance entities (as these entities are regulated separately, and addressed in the insurance risk management section of this report).

The size, composition, RWA component and EC requirement of the Group's equity investments in the banking book are reflected in the following table after recognition of guarantees. As at the reporting date, the statement of financial position value of such investments amounted to **R5 840 million** (30 June 2011: R6 277 million; 31 December 2011: R5 747 million). Of the R5 840 million investment exposure at the reporting date, R5 428 million is held for capital gains purposes and the remainder for strategic and other purposes.

The increase in the equity exposure from the prior year is mainly due to positive revaluations and draw-downs on current investments.

	30 June		31 December
	2012 Rm	2011 Rm	2011 Rm
Statement of financial position	**5 840**	6 277	5 747
Exchange-traded investments, associates and joint ventures[1]	**716**	882	694
Privately held traded investments, associates and joint ventures[2]	**5 124**	5 395	5 053
Fair value of exchange-traded investments, associates and joint ventures[3]	**716**	882	694
Risk-weighted assets	**23 864**	24 136	22 168
Exchange-traded investments, associates and joint ventures	**2 277**	2 647	2 083
Privately held traded investments, associates and joint ventures	**21 587**	21 489	20 085
Economic capital	**3 098**	3 305	3 007
Exchange-traded investments, associates and joint ventures[1]	**548**	610	544
Privately held traded investments, associates and joint ventures[2]	**2 550**	2 695	2 463

Notes

[1]Include significant minority financial investments deducted from net qualifying RC, amounting to **Rnil million** as at 30 June 2012 (30 June 2011: Rnil; 31 December 2011: Rnil).

[2]Include significant minority financial investments deducted from net qualifying RC, amounting to **R27 million** as at 30 June 2012 (30 June 2011: R23 million; 31 December 2011: R26 million).

[3]To address specific SARB Pillar 3 requirements for equity risk in the banking book relating to the value of investments. it should be noted that the difference between the statement of financial position value and fair value of associates and joint ventures amounts to **Rnil** as at 30 June 2012 (30 June 2011: Rnil; 31 December 2011: Rnil). The differences relate to conservative impairments applied on the listed associates, which followed a prudent and considered assessment by the board, therefore resulting in the fair value of the said investments being higher than the statement of financial position values. Additionally, there are no differences between the fair value and market value of exchange traded investments, associates and joint ventures.

Equity investment risk

Approach to equity investment risk *(continued)*

Realised and unrealised gains on equity investments in the banking book as per specific SARB Pillar 3 disclosure requirements are reflected in the following table:

Realised and unrealised gains on equity investments

	30 June		31 December
	2012 Rm	2011 Rm	2011
Cumulative realised gains arising from sales and liquidations	**47**	29	64
Total unrealised gains recognised directly in the statement of financial position	**7**	5	34

To address the specific SARB Pillar 3 disclosure requirements relating to unrealised gains/(losses) for equity risk in the banking book, it should be noted that:

- the Group does not have any latent revaluation gains/(losses), i.e. unrealised gains/(losses) which are not recognised in the statement of financial position or statement of comprehensive income; and
- the Group does not have unrealised gains/(losses) that are recognised in primary or secondary capital and reserve funds without being recognised in the statement of comprehensive income. This is due to an IFRS principle adopted by the Group, i.e. all unrealised gains/(losses) that are not recognised in the statement of comprehensive income cannot be recognised in primary or secondary capital and reserve funds.

Market Risk

Contents

65 – 88
Market risk

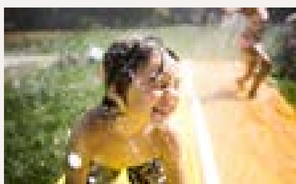
65 Overview

67 Traded market risk

72 Non-traded market risk

79 Insurance risk

Approach to market risk.



Overview

Key points to note

- Traded market risk levels remained subdued, while trading revenues showed resilience under continued challenging market conditions.
- Continued focus on risk management and efficient use of trading capital as increased traded market risk regulatory capital requirements took effect to ensure delivery of favourable risk-adjusted returns.
- Interest rate risk in the banking book continues to be managed to low levels.
- Structural hedge programme contributed positively to interest margin for period when South African interest rates were at an historical low. The programme was efficiently maintained over the period during which key South African interest rates reached historical lows.
- Cash flow hedging reserve increased as a result of favourable mark-to-market movements.

Key perfomance indicators

	30 June		31 December
	2012	2011	2011
Average traded market risk (DVaR) (Rm)	**19,44**	25,80	23,73
Traded market regulatory capital (RC) (at 8% of RWAs) (Rm)	**1 066**	788	669
Banking book AEaR for a 2% interest rate shock (% of Group NII)	**<5%**	<5%	<5%

Introduction

Market risk is the risk that the Group's earnings or capital, or its ability to meet business objectives, will be adversely affected by changes in the level or volatility of market rates or prices such as interest rates, foreign exchange rates, equity prices, commodity prices and credit spreads. The main sources of risk are traded market risk and non-traded interest rate risk. Traded market risk arises in CIBW to support customer trading activity, whereas non-traded interest rate risk arises in the banking book to support customer products.

The MRC provides Group-level market risk oversight and meets monthly to review, challenge and make recommendations concerning key risk owner's assessments of risk appetite, limits, exposure and controls. Oversight for key market risks are provided by the Trading Risk Committee (TRC), Group ALCO and ALCO subcommitees.

Strategy

The Group's market risk management objectives are to:

- understand and control market risk through robust measurement, controls and oversight;
- facilitate business growth within a controlled and transparent risk management framework;
- ensure traded market risk resides mainly in CIBW; and
- ensure a higher degree of interest rate mismatch margin stability and lower interest rate risk over an interest rate cycle in the banking book.

Overview

June 2012 in review

Trading exposures were actively managed to endure challenging market conditions characterised by continued uncertainty, volatility and liquidity constraints. These factors contributed to a subdued trading risk profile, while trading revenues showed resilience in a tough environment. The Group's continued focus on risk management and efficient use of trading capital ensured a favourable risk-adjusted return over the reporting period.

The Group continued to invest in its traded market risk systems to ensure enhanced performance and scalability to support trading expansion plans and regulatory change. Regulatory approval was maintained for use of the DVaR internal models approach for trading book general position risk. The Group implemented the new Stressed VaR (SVaR) based regulatory capital requirements from 2012. In addition, the Group implemented enhancements to the traded market risk economic capital framework from 2012. These enhancements ensure a countercyclical assessment of traded market risk economic capital that is always based on stressed market conditions. Disclosure enhancements were introduced from 2012 to improve visibility of the inflation and credit spread traded asset classes, following testing during 2011.

The Group continued to manage its structural and non-structural banking book interest rate risk to low risk appetite levels during the reporting period.

The structural interest rate hedge programme remains in place and it contributed positively to the interest margin to mitigate the negative endowment impact on equity and structural deposits in the low rate environment. Cash flow hedging reserve were further bolstered, as a result of favourable mark-to-market movements in the structural hedg programme. Cash flow hedge reserves will be released to the statement of comprehensive income on an accrual basis over the average life of the programme should market rates remain at current levels. The structural hedge programme was efficiently maintained over the reporting period which saw key South African interest rates reach historically low levels.

The Group remains exposed to prime-JIBAR basis risk arising from the timing difference between predominantly prime linked assets being funded with liabilities that are primarily JIBAR-linked after hedging. Prepayment and recruitment risk that may arise from fixed rate product offerings to customers continued to be managed on customer behaviour risk principles.

Looking ahead

Euro debt crises and global growth concerns continue to spill over into the South African economy. The Group closely monitors these effects on an ongoing basis.

Given the increase in the minimum regulatory and internal capital requirements for traded market risk, the Group will remain focused on risk-adjusted returns and efficient use of risk capital across trading desks and products. A key focus is flow business with customers, especially where RWA usage is efficient.

The Group continues to expand its product range in African markets including fixed income, commodities and derivatives.

With South African interest rates expected to remain low or to reduce further over the remainder of 2012, the Group will remain focused on the risk of margin compression and efficient maintenance of its structural hedge programme.

Traded market risk

Approach

Traded market risk results primarily from the facilitation of customer trades in the wholesale market including market making, the provision of hedge solutions, pre-hedging and providing assistance to customers in the execution of large trades. Not all customer trades are hedged immediately or completely, giving rise to traded market risk. The Group's policy is to concentrate its traded market risk exposure within CIBW.

Market risk in CIBW occurs within both the trading book and the banking book, as defined for regulatory purposes. Interest rate risk in CIBW's banking book is subjected to the same rigorous measurement and control standards as its trading book, but the associated sensitivities are reported as part of the interest rate risk in the banking book section on pages 72 to 77.

Risk measurement

A suite of comprehensive techniques is used to measure and control traded market risk on a daily basis, which include VaR based measures (incorporating tail risk metrics) and stress testing.

DVaR is an estimate of the potential loss that may arise from unfavourable market movements if current positions were to be held unchanged for one business day.

CIBW uses an internal DVaR model based on the historical simulation method to derive the quantitative market risk measures under normal conditions. The DVaR model utilises a two-year data history of unweighted historical price and rate data and a holding period of one day with a confidence interval of 95%.

The historical simulation methodology can be split into three parts:

- Calculate hypothetical daily profit or loss for each position over the most recent two years, using observed daily market moves.
- Sum of all hypothetical profits or losses for day one across all positions, giving one total profit or loss. Repeat for all other days in the two-year history.
- DVaR is the 95th percentile loss selected from the resultant two-year historically simulated strip of daily hypothetical net profit or loss. Daily losses in excess of the DVaR figure are likely to occur, on average, up to 26 times over the two-year period.

This internal model is also used for measuring value at risk (VaR) over both a one-day and 10-day holding period at a 99% confidence level for regulatory back-testing and RC calculation purposes respectively. CIBW's VaR internal model has been approved by the SARB to calculate RC for certain trading book portfolios. The approval covers general position risk across all interest rate, foreign exchange, commodity, equity and traded credit products. Issuer specific risk is currently reported in accordance with the regulatory standardised approach. Additionally, new products, which are awaiting regulatory approval, are capitalised by using the regulatory standardised approach.

DVaR is an important market risk measurement and control tool. Consequently, the performance of the model is regularly assessed for continued suitability. The main technique employed is back-testing, which counts the number of days when daily trading losses exceed the corresponding VaR estimate. The regulatory standard for back-testing is to measure daily losses against VaR assuming a one-day holding period and a 99% level of confidence. The regulatory green zone of four or less exceptions over a twelve-month period is consistent with a good working VaR model. Back-testing reports are monitored daily. For CIBW's trading book, green model status was maintained during the reporting period.

VaR estimates have a number of limitations:

- Historical simulation assumes that the past is a good representation of the future, which may not always be the case.
- The assumed time horizon does not fully capture the market risk of positions that cannot be closed out or hedged within this time horizon.
- VaR does not indicate the potential loss beyond the selected percentile.
- VaR is based on positions as at the close of business and consequently intra-day risk, the risk from a position bought and sold on the same day, is not captured.
- Prudent valuation practices are used in the VaR calculation when there is difficulty obtaining rate/price information.

Tail risk metrics, stress testing and other sensitivity measures are used to complement VaR.

Tail risk metrics highlight the risk beyond the percentile selected for DVaR. The two tail risk metrics chosen for daily monitoring, using the current portfolio and two years of price and rate history, are:

- the average of the worst three hypothetical losses from the historical simulation; and
- expected shortfall (also referred to as expected tail loss), which is the average of all hypothetical losses from the historical simulation beyond the 95th percentile used for DVaR.

Traded market risk

Traded market risk *(continued)*

Approach *(continued)*

Risk measurement (continued)

Stress testing provides an indication of the potential size of losses that could occur in extreme conditions. Stress testing assists in identifying risk concentrations across business lines and assists senior management in making capital planning decisions. CIBW performs two main types of stress/scenario testing. Firstly, risk factor stress testing is carried out, where extended historical stress moves are applied to each of the main risk categories including interest rate, equity, foreign exchange, commodity and credit spread risk. Secondly, the trading book is subjected to multi-factor scenarios that simulate past periods of significant market disturbance and hypothetical extreme yet plausible events. Scenarios are reviewed at least annually.

Stress results are monitored daily in accordance with a stress limits and triggers framework.

CIBW implemented its new regulatory SVaR model to comply with Basel II.5 revisions to the traded market risk capital as taken up in the amended regulations relating to banks, which became effective on 1 January 2012.

SVaR is an estimate of the potential loss arising from a 12-month period of significant financial stress. SVaR uses DVaR methodology based on inputs calibrated to historical data from a continuous 12-month period that maximises the DVaR based regulatory capital at a specified confidence level.

The Group's SVaR model was approved by the SARB, which approval matches the scope of the DVaR model as used for regulatory capital calculations, and an SVaR model multiplier was assigned. The stress capital requirement based on SVaR is calculated daily and is disclosed for the period under review.

Risk control

Risk limits are set and reviewed at least annually to control CIBW's trading activities in line with the defined risk appetite of the Group. The criteria for setting risk limits include relevant market analysis, market liquidity and business strategy. Trading risk limits are set at aggregate, risk category and lower levels and are expressed in terms of DVaR. This is further supported by a comprehensive set of sensitivity limits, including foreign exchange position limits, interest rate delta limits, option-based limits, tail risk and stress triggers and limits. Performance triggers are also used as part of the risk management process.

Valuation control, independent price testing and bid-offer testing are conducted by CIBW's product control group and the results are reviewed monthly by CIBW's Valuation Governance and Control Committee.

Risk reporting

CIBW's Market Risk team produces a number of detailed and summary market risk reports on a daily and monthly basis. These reports summarise the positions, risks and top stresses covering interest rate, foreign exchange, equity, commodity and credit spread. CIBW market risk reports are sent to Group Market Risk for review and inclusion in the monthly MRC and other governance committee reports, as required.

Analysis of risk exposure

Disclosure enhancements were introduced in 2012 to improve visibility of the inflation and credit spread traded asset classes following testing during 2011. For the reporting period general interest rate, inflation and credit spread risks are disclosed separately, whereas in previous reporting periods these items were presented together, on a diversified basis, under the heading of interest rate risk. The reported diversification effect across asset classes is impacted by the enhanced basis of disclosure and thus not directly comparable to previous reporting periods.

The following table reflects the 95% DVaR and expected shortfall statistics for CIBW's trading book activities as measured by the Group's Internal Models Approach (IMA) for general trading position risk. CIBW's traded market risk exposure, as measured by average total DVaR, decreased to **R19,44 million** for the reporting period, which is down 25% compared to the six months ended 30 June 2011 (R25,80 million) and down 18% compared to the full 2011 financial year (R23,73 million). This was principally due to a decrease in average fixed income risk held overnight. Average DVaR over the reporting period has been generally muted due to continued challenging market conditions and lower customer activity. CIBW's business model is orientated around customer flow and the risk profile is maintained so that it is aligned with near-term demands of our customers. Trading revenues however showed resilience, and a favourable risk-adjusted return was achieved for the reporting period.

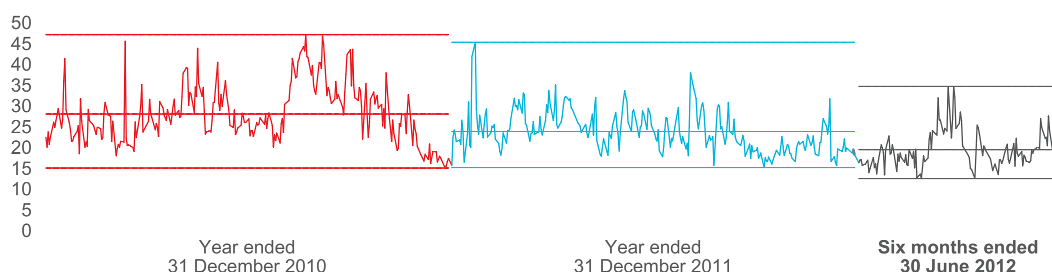
Traded market risk

CIBW's trading book DVaR summary

	Six months ended 30 June								Year ended 31 December			
	2012				2011				2011			
	Average Rm	**High[1] Rm**	**Low[1] Rm**	**As at 30 June Rm**	Average Rm	High[1] Rm	Low[1] Rm	As at 30 June Rm	Average Rm	High[1] Rm	Low[1] Rm	As at 31 Dec Rm
Interest rate risk[2]	**16,86**	**30,71**	**8,84**	**16,46**	21,10	36,69	15,31	23,18	19,09	36,69	10,67	14,12
Foreign exchange risk	**8,30**	**21,34**	**2,13**	**7,32**	8,94	25,68	1,89	6,67	8,13	25,68	1,89	5,07
Equity risk	**5,50**	**12,18**	**3,23**	**7,34**	4,17	7,73	2,38	2,94	4,76	10,83	2,38	5,18
Commodity risk	**0,94**	**1,97**	**0,32**	**0,83**	1,96	4,12	0,72	2,79	1,87	6,55	0,32	1,30
Inflation risk[2]	**9,68**	**17,95**	**3,23**	**4,72**	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Credit spread risk[2]	**4,86**	**5,76**	**2,97**	**5,07**	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Diversification effect	**(26,70)**	**n/a**	**n/a**	**(18,33)**	(10,37)	n/a	n/a	(7,87)	(10,12)	n/a	n/a	(7,35)
Total DVaR[3]	**19,44**	**34,38**	**12,66**	**23,42**	25,80	44,77	15,75	27,71	23,73	44,77	15,22	18,32
Expected shortfall	**27,68**	**49,65**	**17,58**	**33,32**	39,20	60,12	25,94	44,54	34,88	60,12	21,57	26,73
Regulatory VaR[3]	**32,31**	**53,67**	**20,11**	**41,40**	42,23	74,98	23,97	51,71	39,64	74,98	24,52	29,30
Regulatory SVaR[4]	**47,85**	**93,58**	**30,14**	**51,21**	n/a	na	n/a	n/a	n/a	n/a	n/a	n/a

The following graph shows the daily history of CIBW's total trading book DVaR for 2010 and 2011 and the six months ended 30 June 2012, along with the period averages and highs and lows. In comparison with 2010 and continuing the trend for 2011 and the first half of 2012, the DVaR has demonstrated reduced variability, lower average risk levels and a reduction in large DVaR days. CIBW does, on some occasions in the conduct of customer transactions, take on significantly larger than usual market risk. However, this is always undertaken within the Group's market risk governance framework.

CIBW's daily trading book DVaR (daily values, period average, high and low) (Rm)



Notes

[1]The high and low DVaR figures reported for each category did not necessarily occur on the same day as the high (and low) total DVaR. Consequently, a diversification effect number for the high (and low) DVaR figures would not be meaningful and is therefore omitted from the above table.

[2]Inflation and credit spread risk were previously reported together with interest rate risk. Comparative DVaR values for 31 December 2011 (on an undiversified basis) for interest rate, inflation and credit spread risk were R21,01 million, R11,66 million and R4,33 million respectively. No data is available for the period ended 30 June 2011.

[3]Regulatory VaR and SVaR are reported with a 1-day holding period at a 99% confidence level. Consequently these figures are not directly comparable to the 95% risk metrics reported in the rest of the table.

[4]The SVaR period as required from 1 January 2012, is 1 April 2008 to 31 March 2009. This period is subject to on-going review for appropriateness.

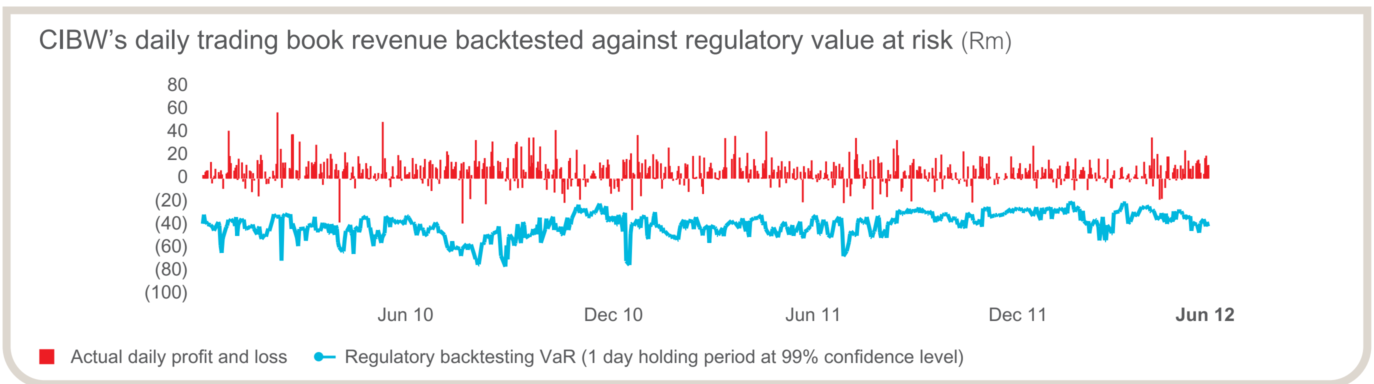
Traded market risk

Traded market risk *(continued)*

Comparison of VAR estimates with trading revenues

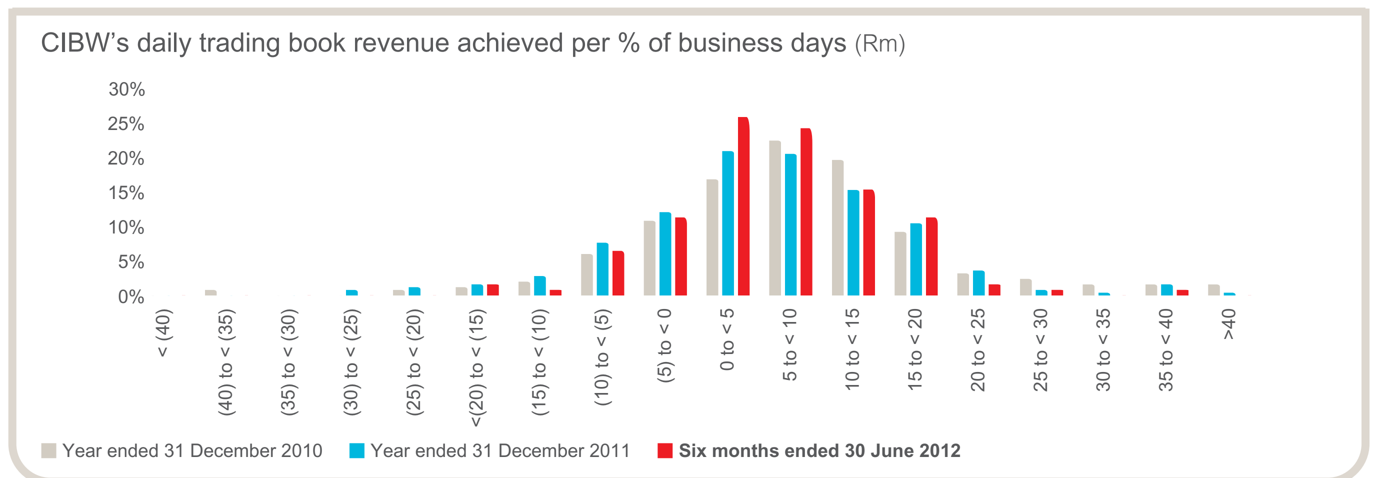
The following graph compares the total VaR estimates over a one-day holding period at a 99% confidence level with the daily revenues generated by the trading units from 2010 to 2011 and the six months ended 30 June 2012. Revenue as reported here relates to actual trading book revenue only, excluding fees, commissions, bid- ask spreads and net interest income, as required for regulatory back-testing purposes.

Over the six months to the reporting date, there were no instances where an actual daily trading loss exceeded the corresponding VaR estimate which is the same as in the prior reporting



Analysis of trading revenue

The following histogram depicts the distribution of daily trading revenue for the CIBW trading book for the years ended 31 December 2010 and 2011, and the six months ended 30 June 2012. Revenue includes net trading book income, excluding net fee and commission. The distributions are skewed to the profit side. The average daily trading revenue for the reporting period decreased compared to that of 2011 due to fewer larger profit days. Although partially offset by a higher frequency of smaller profit days. The percentage of positive revenue days increased to 80% for the six months to 30 June 2012 (30 June 2011: 79%; 31 December 2011: 74%), indicating a reduced number of loss days.



Traded market risk *(continued)*

Minimum RC requirement

The Group's traded market risk minimum RC requirement comprises two elements:

- Trading book positions, where the market risk is measured under a SARB approved internal model, including VaR and SVaR. The capital requirement is calculated based on the internal model with a 10-day holding period at a 99% confidence level, and other regulatory 60-day averaging and capital multiplier specifications. This approach currently applies to close to 100% of the Group's general position risk across interest rate, inflation, foreign exchange, commodity, equity and traded credit products.
- Trading book positions which have not yet met the SARB approval or the Group's internal conditions for inclusion within the approved internal models approach. The capital requirement is calculated using standardised regulatory rules. This approach currently applies to the Group's issuer specific risk exposures.

The total traded market risk minimum capital requirement increased by 59% or R398 million from December 2011 to the reporting date. This increase was principally due to the introduction of an additional minimum capital requirement based on SVaR from 1 January 2012 under the amended regulations relating to banks.

Minimum RC requirement (at 8% of RWAs) for traded market risk

	30 June		31 December
	2012 Rm	2011 Rm	2011 Rm
Internal models approach (DVaR model based)	**807**	543	362
VaR	**337**	543	362
SVaR[1]	**470**	n/a	n/a
Standardised approach	**259**	245	307
Interest rate risk	**207**	132	226
Equity risk	**52**	59	81
Foreign exchange risk, including gold	**—**	—	—
Commodity risk	**—**	—	—
Options	**—**	54	—
Total traded market risk capital requirement	**1 066**	788	669

Note

[1]No data available for prior reporting periods.

Non-traded market risk

Interest rate risk in the banking book

Approach

Interest rate risk is the risk that the Group's financial position may be adversely affected by changes in interest rate levels, yield curves and spreads. Non-traded interest rate risk arises in the banking book from the provision of retail and wholesale (non-traded) banking products and services, as well as from certain structural exposures within the statement of financial position, mainly due to repricing timing differences between assets, liabilities and equity. These risks impact both the earnings and the economic value of the Group.

The Group's objective for managing interest rate risk in the banking book is to ensure a higher degree of interest rate mismatch margin stability and lower interest rate risk over an interest rate cycle. This is achieved by transferring the interest rate risk from the business to the local treasury or Group Treasury, which in turn hedges material net exposures with the external market. As a result of mainly timing considerations, interest rate risk may arise when some of the net position remains with Group Treasury. A limits framework is in place to ensure that retained risk remains within approved risk appetite.

Risk management strategies considered include:

- strategies regarding changes in the volume, composition, pricing and interest rate risk characteristics of assets and liabilities; and
- the execution of applicable derivative contracts to maintain the Group's interest rate risk exposure within limits.

Where possible, hedge accounting is applied to derivatives that are used to hedge interest rate risk in the banking book. In cases where hedge relationships do not qualify for hedge accounting, mismatches may arise due to different bases used in fair valuing the hedges and the underlying banking book exposure. Applicable accounting rules, as detailed in the Group's accounting policies, are followed.

Structural interest rate risk arises from the variability of income from non-interest bearing products, managed variable rate products and the Group's equity, and is managed by Group Treasury.

Interest rate risk also arises in each of the African subsidiaries' treasuries in the normal course of managing the statement of financial position and facilitating customer activity. The risk is managed by the local treasury functions, subject to modest risk limits and other controls.

Embedded customer optionality risk may also give rise to interest rate risk in the banking book. This risk arises from a customer's right to buy, sell or in some manner alter the cash flow of a financial contract. Embedded customer optionality is distinct from direct optionality, which arises through the underlying product structure (e.g. capped rate loan products). The Group's policy requires such direct option risk to be hedged explicitly.

Prepayment risk arises in relation to transactions where an early settlement option is embedded in the product. This risk most commonly arises in relation to fixed rate loans offered to retail customers, where the customer has an option to repay the loan prior to contractual maturity and where the Group is unable to collect full market related compensation. The risk is controlled through book and term limits, funding (hedging) new loans according to the expected behavioural repayment profile and tracking deviations of actual customer behaviour from the expected profile. The risk is monitored monthly.

Recruitment risk arises when the Group commits to providing a product at a predetermined price for a period into the future. Customers have the option to take up this offer. Controls include campaign rules, pre-funding of anticipated take-up and the management of the resultant residual risk.

Embedded customer optionality risk was not material during the reporting period.

Interest rate risk in the banking book *(continued)*

Approach *(continued)*

Risk Measurement

The techniques used to measure and control interest rate risk in the banking book include repricing profiles, annual earnings at risk (AEaR), DVaR and tail metrics, economic value of equity sensitivity and stress testing.

With the repricing profile, instruments are allocated to time periods with reference to the earlier of the next contractual interest rate repricing date and the maturity date. Instruments which have no explicit contractual repricing or maturity dates are placed in time buckets based on the most likely repricing behaviour. Currently, the contractual profiles of assets are not adjusted for customer prepayment features.

AEaR measures the sensitivity of net interest income over the next 12 months to a specified shock in interest rates. AEaR is assessed across a range of interest rate scenarios, including parallel and key rate shocks and yield curve twists and inversions as appropriate for each business. The AEaR calculation takes the assumed behavioural profile of relevant structural product balances into account. Currently, the contractual profiles of assets are not adjusted for customer prepayment features.

The Group uses a sensitivity based approach to calculate DVaR at a 95% confidence level for measuring interest rate risk in the banking book. The DVaR is monitored against approved internal limits, and is used as a complementary tool to AEaR. DVaR is also supplemented by tail metrics.

Economic value of equity (EVE) sensitivity measures the sensitivity of the present value of the banking book at a specific point in time to a specified shock to the yield curve. Like DVaR EVE is present value sensitivity, and is complementary to income sensitivity measures such as AEaR.

Stress testing is carried out by Group Treasury and the risk functions in the African subsidiaries to supplement DVaR and AEaR metrics. The stress testing is tailored to each banking book and consists of a combination of stress scenarios and historical stress movements applied to the respective banking books.

Risk control

Market risk is controlled through the use of DVaR and AEaR limits and supported by monthly monitoring of the risk profiles, EVE sensitivity and stress results. Limits are set at the business level and then cascaded down. The business level limits for DVaR and AEaR are agreed at the MRC. Compliance with limits is monitored by the respective business market risk teams with oversight provided by Group Treasury.

Risk reporting

DVaR in respect of Group Treasury is reported daily while the DVaR of the African subsidiaries' treasuries is reported monthly. The repricing profiles, AEaR, EVE sensitivity and stress results are reported monthly for both Group Treasury and the African subsidiaries.

Interest rate sensitivity analyses

Three separate interest rate sensitivity analyses for the Group's banking book are set out in the tables that follow, namely, the repricing profile of the book and the potential effect of changes in market interest rates on annual earnings and equity reserves.

Repricing profile

The repricing profile of the Group's domestic, African subsidiaries and consolidated banking books shows that the consolidated banking book remains asset sensitive, or positively gapped, as interest-earning assets reprice sooner than interest-paying liabilities before and after derivative hedging activities. Accordingly, future net interest income remains vulnerable to a decrease in market interest rates. Asset sensitivity, as represented by the cumulative 12-month interest rate gap, increased from 30 June 2011 to 30 June 2012, but remains fairly stable as a percentage of assets.

Non-traded market risk

Interest rate risk in the banking book *(continued)*

Interest rate sensitivity analyses *(continued)*

Repricing profile (continued)

Expected repricing profile

	30 June 2012			
	On demand – 3 months Rm	4 – 6 months Rm	7 – 12 months Rm	Over 12 months Rm
Domestic bank book[1]				
Interest rate sensitivity gap	128 562	(24 417)	(32 027)	(34 268)
Derivatives[2]	(88 385)	16 444	14 214	57 727
Net interest rate sensitivity gap	40 177	(7 973)	(17 813)	23 459
Cumulative interest rate gap	40 177	32 204	14 391	37 850
Cumulative gap as a percentage of Absa Bank Limited's total assets (%)	5,3	4,2	1,9	4,9
Foreign subsidiaries' bank books[3]				
Interest rate sensitivity gap	2 481	(257)	1 650	379
Derivatives[2]	116	3	1	(108)
Net interest rate sensitivity gap	2 597	(254)	1 651	271
Cumulative interest rate gap	2 597	2 343	3 994	4 265
Cumulative gap as a percentage of foreign subsidiaries' total assets (%)	23,1	20,8	35,5	37,9
Total				
Cumulative interest rate gap	42 774	34 547	18 385	42 115
Cumulative gap as a percentage of the Group's total assets (%)	5,3	4,3	2,3	5,2

	30 June 2011			
	On demand – 3 months Rm	4 – 6 months Rm	7 – 12 months Rm	Over 12 months Rm
Domestic bank book[1]				
Interest rate sensitivity gap	130 760	(27 463)	(35 299)	(34 048)
Derivatives[2]	(100 965)	17 334	23 422	60 209
Net interest rate sensitivity gap	29 795	(10 129)	(11 877)	26 161
Cumulative interest rate gap	29 795	19 666	7 789	33 950
Cumulative gap as a percentage of Absa Bank Limited's total assets (%)	4,4	2,9	1,1	5,0
Foreign subsidiaries' bank books[3]				
Interest rate sensitivity gap	1 729	(70)	1 477	472
Derivatives[2]	115	(0)	(12)	(114)
Net interest rate sensitivity gap	1 844	(70)	1 465	358
Cumulative interest rate gap	1 844	1 774	3 239	3 597
Cumulative gap as a percentage of foreign subsidiaries' total assets (%)	19,2	18,5	33,8	37,5
Total				
Cumulative interest rate gap	31 639	21 440	11 028	37 547
Cumulative gap as a percentage of the Group's total assets (%)	4,4	3,0	1,5	5,2

Notes
[1]Includes exposures held in the CIBW banking book.
[2]Derivatives for interest rate risk management purposes (net nominal value).
[3]Includes NBC and BBM.

Interest rate risk in the banking book *(continued)*

Interest rate sensitivity analyses *(continued)*

Repricing profile (continued)

Expected repricing profile

	31 December 2011			
	On demand – 3 months Rm	4 – 6 months Rm	7 – 12 months Rm	Over 12 months Rm
Domestic bank book[1]				
Interest rate sensitivity gap	120 325	(25 540)	(27 532)	(31 985)
Derivatives[2]	(82 439)	11 087	16 484	54 868
Net interest rate sensitivity gap	37 886	(14 453)	(11 048)	22 883
Cumulative interest rate gap	37 886	23 433	12 385	35 268
Cumulative gap as a percentage of Absa Bank Limited's total assets (%)	5,1	3,2	1,7	4,8
Foreign subsidiaries' bank books[3]				
Interest rate sensitivity gap	1 974	1 843	(236)	472
Derivatives[2]	111	11	9	(122)
Net interest rate sensitivity gap	2 085	1 854	(227)	350
Cumulative interest rate gap	2 085	3 939	3 712	4 062
Cumulative gap as a percentage of foreign subsidiaries' total assets (%)	17,5	33,1	31,2	34,1
Total				
Cumulative interest rate gap	39 971	27 372	16 097	39 330
Cumulative gap as a percentage of the Group's total assets (%)	5,1	3,5	2,0	5,0

Notes

[1]Includes exposures held in the CIBW banking book.

[2]Derivatives for interest rate risk management purposes (net nominal value).

[3]Includes NBC and BBM.

Non-traded market risk

Interest rate risk in the banking book *(continued)*

Interest rate sensitivity analyses *(continued)*

Impact on earnings

The following table shows the AEaR from impacts to net interest income for 100 and 200 bps up and down movements in market interest rates for the Group's banking books. Assuming no management action is taken in response to market interest rate movements, a hypothetical, immediate and sustained parallel decrease of 200 bps in all market interest rates would, as at the reporting date, result in a pre-tax reduction in projected 12-month net interest income of R944 million (30 June 2011: R565 million: 31 December 2011: R475 million). A similar increase would result in an increase in projected 12-month net interest income of R964 million (30 June 2011: R597 million: 31 December 2011: R464 million). AEaR remains low, at well below 5% of the Group's net interest income, for a 200 bps rate shock.

A sensitivity analysis by major currency market interest rates indicates that earnings sensitivity to South African Rand (ZAR) market interest rates constitutes 95% of the total earnings at risk as at the reporting date (30 June 2011: 93%: 31 December 2011: 86%), therefore indicating that the Group remains primarily exposed to South African market interest rates.

AEaR for 100 and 200 bps changes in market interest rates

	200 bps decrease	100 bps decrease	100 bps increase	200 bps increase
30 June 2012				
Domestic bank book[1] (Rm)	**(894)**	**(454)**	**448**	**914**
Foreign subsidiaries' bank books[2] (Rm)	**(50)**	**(25)**	**25**	**50**
	(944)	**(479)**	**473**	**964**
Percentage of the Group's net interest income (%)	**(3,8)**	**(1,9)**	**1,9**	**3,9**
Percentage of the Group's equity (%)	**(1,3)**	**(0,7)**	**0,7**	**1,4**
30 June 2011				
Domestic bank book[1] (Rm)	(526)	(258)	271	558
Foreign subsidiaries' bank books[2] (Rm)	(39)	(19)	19	39
	(565)	(277)	290	597
Percentage of the Group's net interest income (%)	(2,4)	(1,2)	1,2	2,5
Percentage of the Group's equity (%)	(0,9)	(0,4)	0,5	0,9
31 December 2011				
Domestic bank book[1] (Rm)	(411)	(208)	191	400
Foreign subsidiaries' bank books[2] (Rm)	(64)	(32)	32	64
	(475)	(240)	223	464
Percentage of the Group's net interest income (%)	(1,9)	(1,0)	0,9	1,9
Percentage of the Group's equity (%)	(0,7)	(0,4)	0,3	0,7

Impact on equity reserves

Market interest rate changes may affect equity (capital) in the following three ways:

- higher or lower profit after tax resulting from higher or lower net interest income;
- higher or lower available-for-sale reserves reflecting higher or lower fair values of available-for-sale financial instruments; and
- higher or lower values of derivatives held in the cash flow hedging reserve.

Notes

[1]Includes Absa Bank Limited's domestic banking book, which includes exposures held in the CIBW banking book.

[2]Includes NBC and BBM. African subsidiaries' interest rate sensitivities are shown on a 100% (rather than actual) shareholding basis.

Interest rate risk in the banking book *(continued)*

Interest rate sensitivity analyses *(continued)*

Impact on equity reserves (continued)

The pre-tax effect of net interest income sensitivity is reported in the preceding sensitivity analysis. The effect of taxation can be estimated using the 2012 tax rate. The equity reserve sensitivities that follow are illustrative, based on simplified scenarios, and consider the impact on the cash flow hedges and available-for-sale portfolios which are mark-to-market through reserves. The impact on equity is calculated by revaluing the fixed rate available-for-sale financial assets, including the effect of any associated hedges and derivatives designated as cash flow hedges, for an assumed change in market interest rates.

The decreased sensitivity of cash flow hedging reserves is due to an increase in the hedging activity of structural balances. The increased sensitivity of available-for-sale reserves is due to additional statutory liquid assets purchased during the reporting period, classified as available-for-sale.

Sensitivity of reserves to market interest rate movements

	30 June 2012			30 June 2011			31 December 2011		
	Impact on equity Rm	**Maximum impact[1] Rm**	**Minimum impact[1] Rm**	Impact on equity Rm	Maximum impact[1] Rm	Minimum impact[1] Rm	Impact on equity Rm	Maximum impact[1] Rm	Minimum impact[1] Rm
+ 100 bps parallel move in all yield curves									
Available-for-sale reserve	**(1 015)**	**(1 015)**	**(955)**	(831)	(831)	(793)	(1 005)	(1 012)	(793)
Cash flow hedging reserve	**(1 748)**	**(1 748)**	**(1 671)**	(1 724)	(1 748)	(1 671)	(1 664)	(1 758)	(1 652)
Total	**(2 763)**	**(2 763)**	**(2 663)**	(2 555)	(2 563)	(2 464)	(2 669)	(2 705)	(2 464)
As a percentage of Group equity (%)	**(3,9)**	**(3,9)**	**(3,8)**	(4,7)	(4,7)	(4,6)	(3,9)	(4,0)	(3,6)
– 100 bps parallel move in all yield curves									
Available-for-sale reserve	**1 015**	**1 015**	**955**	831	831	793	1 005	1 012	793
Cash flow hedging reserve	**1 748**	**1 748**	**1 671**	1 724	1 748	1 671	1 664	1 758	1 652
Total	**2 763**	**2 763**	**2 663**	2 555	2 563	2 464	2 669	2 705	2 464
As a percentage of Group equity (%)	**3,9**	**3,9**	**3,8**	4,7	4,7	4,6	3,9	4,0	3,6

Foreign exchange risk

Approach

The Group is exposed to two sources of foreign exchange risk, namely, transactional and translational risk.

Transactional foreign exchange risk

Transactional foreign exchange risk arises when the banking assets and liabilities are not denominated in the functional currency of the transacting entity. The Group's policy is for transactional foreign exchange risk to be concentrated and managed within the CIBW trading book.

Some transactional foreign exchange risk also arises within the African subsidiaries' treasuries in the course of foreign currency balance sheet management and facilitation of customer activity. This risk is minimised through modest transactional open position and DVaR limits, as approved by the MRC. Foreign exchange risk is monitored daily against these limits. Average foreign exchange DVaR for the reporting period amounted to R0,4 million (30 June 2011: R0,3 million; 31 December 2011: R0,3 million) on an undiversified basis across these treasuries.

In accordance with Group policy, there were no significant net open currency positions outside the CIBW trading book at the reporting date that would give rise to material foreign exchange gains and losses being recognised in the statement of comprehensive income or in equity as a result of a foreign exchange rate shock.

The Group's investments in foreign currency subsidiaries and branches create capital resources denominated in foreign currencies. Changes in the ZAR value of the investments resulting from foreign currency movements are captured in the currency translation reserve, which are currently excluded from qualifying capital resources under SARB rules.

Note

[1]The maximum and minimum impacts reported for each reserve category did not necessarily occur for the same month as the maximum and minimum impact reported for the total.

Non-traded market risk

Foreign exchange risk *(continued)*

Approach *(continued)*

Foreign currency translation sensitivity analysis (continued)

The following table depicts the carrying value of foreign currency net investments and the pre-tax impact on equity of a 5% change in the exchange rate between ZAR and the relevant functional foreign currencies.

Functional foreign currency	Sterling Rm	Tanzanian shilling Rm	Mozambican metical Rm	Botswana pula Rm	Zambian kwacha Rm	Total Rm
As at 30 June 2012						
Foreign currency net investments	**1 943**	**326**	**528**	**30**	**15**	**2 842**
Impact on equity from a 5% currency translation shock	**97**	**16**	**26**	**2**	**1**	**142**
As at 30 June 2011						
Foreign currency net investments	1 619	310	452	—	—	2 381
Impact on equity from a 5% currency translation shock	81	15	23	—	—	119
As at 31 December 2011						
Foreign currency net investments	1 902	432	556	5	—	2 895
Impact on equity from a 5% currency translation shock	95	22	28	—	—	145

The impact of a change in the exchange rate between ZAR and any relevant currencies, would be:

- a higher or lower ZAR equivalent value of non-ZAR denominated capital resources and RWAs. This includes a higher or lower currency translation reserve within equity, representing the translation of non-ZAR subsidiaries, branches and associates, the impact of foreign exchange rate changes on derivatives and borrowings designated as hedges of net investments;
- a higher or lower profit after tax, arising from changes in the exchange rates used to translate items in the statement of comprehensive income; and
- a higher or lower value of available-for-sale investments denominated in foreign currencies, impacting the available for-sale reserve.

Other market risks

The Group maintains different pension plans with defined benefit and defined contribution structures for current and former employees. In respect of defined benefit plans, the ability to meet the projected pension payments is maintained through investments and regular contributions. Market risk arises when the estimated market value of the pension plan assets decline, their investment returns reduce, or when the estimated value of the pension liabilities increase, resulting in a funding deficit. In these circumstances, the Group could be required or might choose to make additional contributions to the defined benefit plan.

Asset management structural market risk arises where the fee and commission income earned by asset management products and businesses is effected by a change in market levels, primarily through the link between income and the value of assets under management. The risk is measured in terms of AEaR to reflect the sensitivity of annual earnings to shocks in market rates. Group policy dictates that businesses monitor, report and regularly assess potential hedging strategies relating to this risk. Exposure to this risk currently arises mainly within AFS. Asset management structural risk was not material during the period reporting.

Key points to note

- A new life insurance entity, Barclays Life Zambia, will commence writing business in August 2012.
- A hedging solution has been implemented for Absa Life Limited's maturity guarantees effective 1 July 2012.
- All insurance risk types remained well within the set insurance appetite.
- A rebalancing of Absa Life Limited's offshore investment portfolios is being implemented.
- Absa's local insurance entities continued with preparations to meet Solvency Assessment and Management (SAM) legislation requirements.
- Short-term insurance loss ratios continued to be stable.

Key performance indicators

	30 June		31 December
	2012 %	2011 %	2011 %
Short-term loss ratio	**68,7**	68,2	67,4
Life new business margin	**8,1**	8,5	7,4
Return on shareholders' assets versus benchmark	**3,8 vs 4,1**	2,3 vs 2,6	7,3 vs 6,9

Introduction

Insurance risk is the risk that future claims and expenses will exceed the allowance for expected claims and expenses in measuring policyholder liabilities and in product pricing. Within the Group, four categories of insurance risk are recognised, namely short-term insurance underwriting risk, life insurance underwriting risk, life insurance mismatch risk and life and short-term insurance investment risk. These four categories of insurance risk are managed within different entities within the Group.

Within the Absa Financial Services cluster, the different risk types are managed through specific committees, as set out below:

- **Short-term insurance underwriting risk** is managed through underwriting authority mandates and through referral to an Underwriting Review Committee, as and when required. Risk governance is monitored by the Governance and Control Committees, the Actuarial Review Committee and Key Risk reporting.
- **Life insurance underwriting** is monitored on a monthly basis by an Underwriting Risk Forum, to ensure that the risk taken is in line with the risk priced and reserved for. Risk governance is monitored by the Governance and Control Committees, the Actuarial Review Committee and Key Risk reporting.
- **Life insurance mismatch risk** is monitored on a monthly basis by the Investment Risk Committee. A quarterly review is conducted by the Absa Financial Services Capital and Investment Risk Committee and an annual review by the Actuarial Review Committee.
- **Investment risk** is monitored by the Entity Investment Risk Committees on a monthly basis.

Strategy

The Group's insurance risk management objectives are to:

- ensure risk management and governance provide the foundation for long-term sustainability of the insurance businesses;
- pursue profitable growth opportunities while maintaining a healthy balance between growth and risk;
- seek diverse business opportunities through business lines which complement the traditional bancassurance products;
- balance exposure between life and short-term insurance to harness the benefit of the relative independence of the life and short-term business risks; and
- identify opportunities to grow risk exposures outside South Africa where there is low or negative correlation to corresponding South African risks.

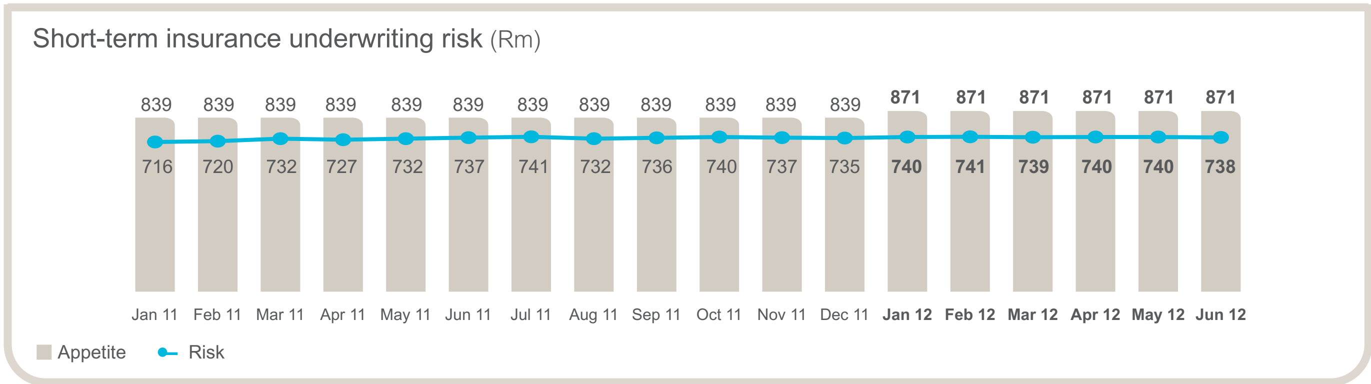
Insurance risk

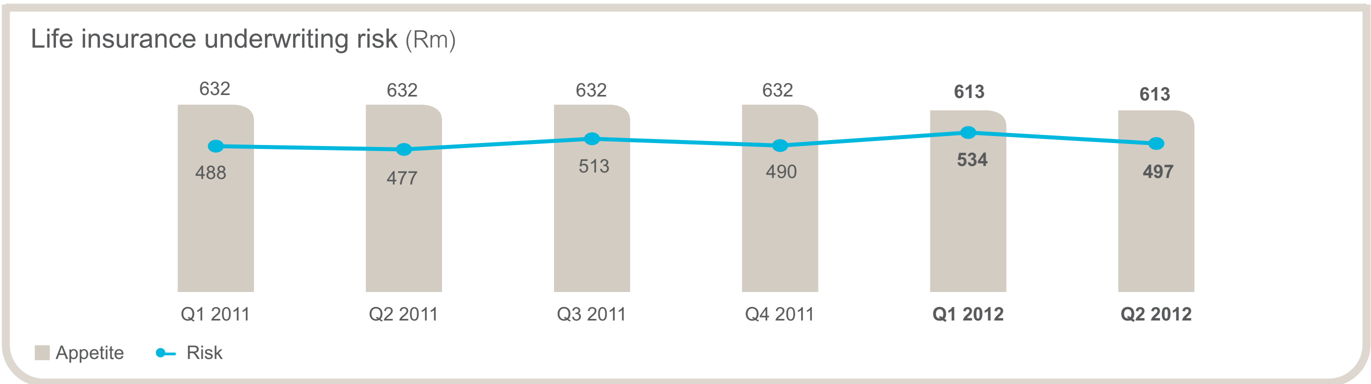
June 2012 in review

All insurance risk types have remained well within the set appetite limits. There has been continued focus on profitability management per product line with corrective measures being implemented to ensure products meet the required levels of return.

The development of the new regulatory solvency requirements for South African insurance entities, the SAM initiative, is progressing well. Absa's local insurance entities continue to stay abreast of developments and to prepare for the SAM requirements that are likely to be legislated. In line with the Group's One Africa strategy, Barclays Life Zambia, a new life insurance company will commence business in August 2012.

Management monitored short-term and life insurance underwriting risk utilisation on a monthly and quarterly basis against the appetite levels set for 2012. The utilisation varied in accordance with expectations and in line with underlying business growth. Utilisation for both categories of risk remained within appetite for the reporting period.

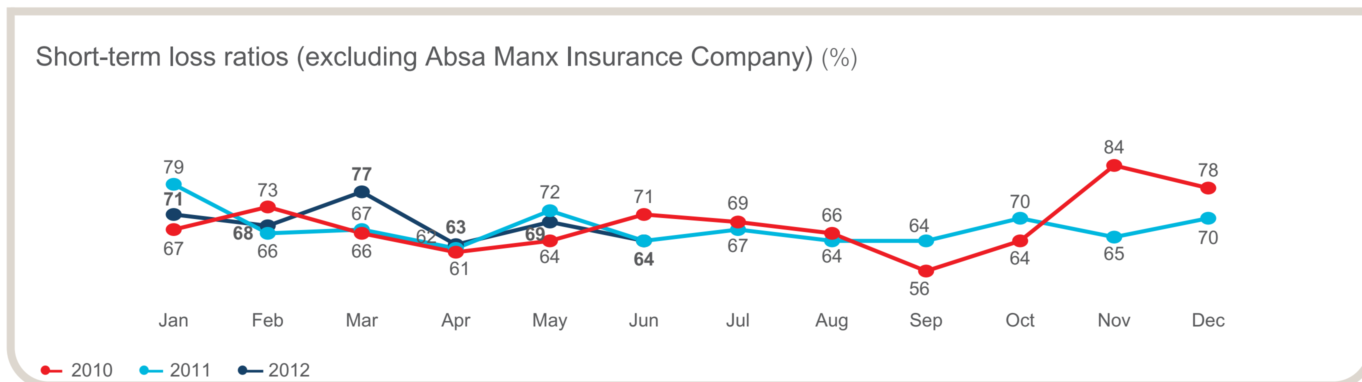




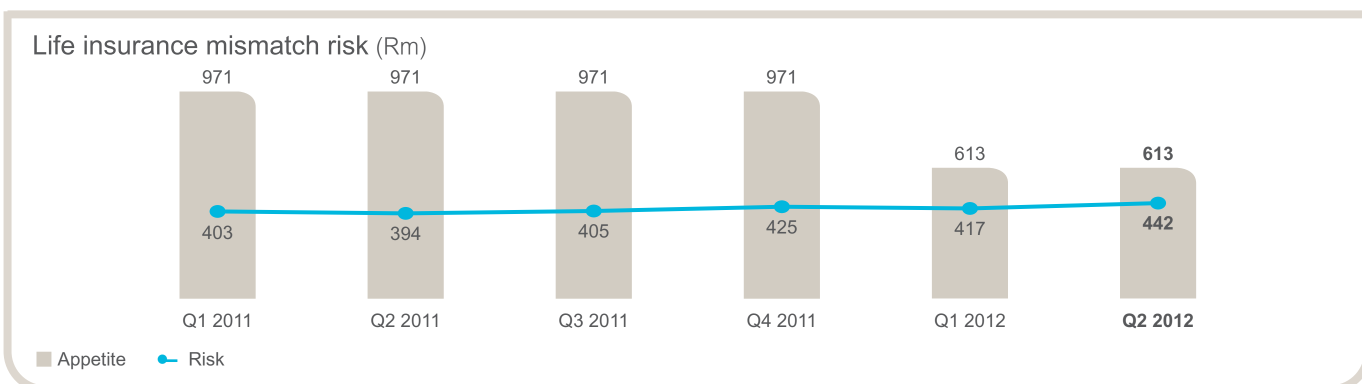
Insurance risk

June 2012 in review *(continued)*

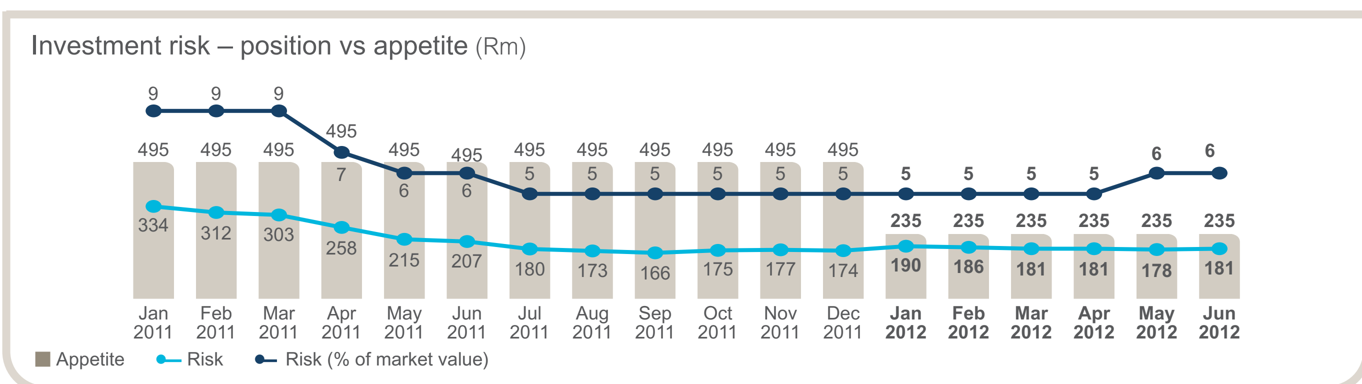
Short-term insurance loss ratios were flat over the reporting period despite drought-related claims in agricultural crop insurance.



Life insurance mismatch risk remained well within appetite over the reporting period.



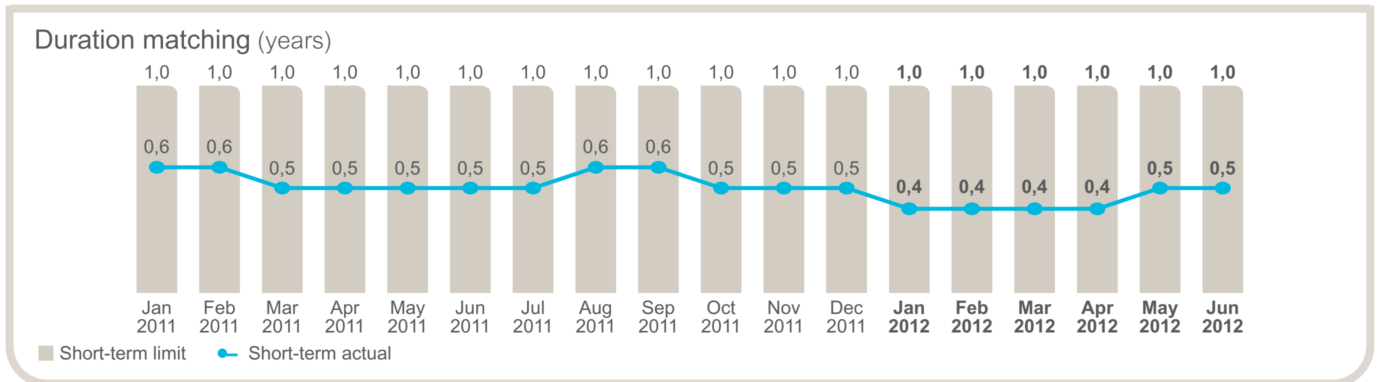
Investment risk remained flat over the reporting period.



Insurance risk

June 2012 in review *(continued)*

The duration of the interest-bearing investments backing short-term insurance policyholder liabilities remained within the limit set.



Looking ahead

The business will continue to develop the capital model for the short-term insurance environment and will maintain focus on driving product profitability to meet targeted returns on capital allocated to individual product lines. Preparations for the implementation of the SAM legislation will continue.

Management will continue to focus on diversifying risk between business lines and between South African and non-South African risks. Risk reporting and measurement will be enhanced with the aim of improving the monitoring of risk appetites and capital requirements across the insurance businesses and, in particular, in respect of non-South African insurance exposures.

Approach to insurance risk

The four categories of insurance risk recognised within the Group are defined as:

- **Short-term insurance underwriting risk**
  The risk associated with underwriting fixed and/or moveable assets, accidents, guarantees and liabilities.
- **Life insurance underwriting risk**
  The risk associated with insuring the lives and/or health of individuals or groups of individuals.
- **Life insurance mismatch risk**
  The risk that the profile of assets held to back Absa Life Limited's policyholder liabilities is inappropriate to match the profile of these liabilities.
- **Life and short-term insurance investment risk**
  The risk associated with changes in asset values and includes interest rate, foreign exchange and equity investment risk.

Short-term insurance underwriting activities are undertaken by Absa Insurance Company, Absa Insurance Risk Management Services, Absa *idirect* and Absa Manx Insurance Company (Absa Manx). Absa Manx has closed for new business and the risks are currently in run-off. Life insurance underwriting activities are undertaken by Absa Life, Absa Life Botswana, Woolworths Financial Services (through an Absa Life cell captive) and will be taken on by Barclays Life Zambia from August 2012. Global Alliance Mozambique underwrites both life and short-term insurance business.

Short-term insurance underwriting risk, life insurance underwriting risk, life insurance mismatch risk and investment risk are core to the business of the insurance entities. The successful management of these risks ultimately determines the success of the entities.

Risk management

Short-term insurance underwriting risk

Management monitors loss ratios on a monthly basis and identifies portions of the business where claims are increasing compared to underlying premiums. In addition, reviews of rates and policy conditions are carried out, when necessary, to determine if any changes are needed. Volumes of business are monitored for increases in volumes out of line with expectations, indicating rates may be low compared to market rates. There are extensive measures in place to control claims which include assessing the claims, checking total potential claims against the sum insured (averaging) and bulk purchase of items required for repair of damaged insured items. The following table summarises risk management measures implemented per short-term insurance product line.

Approach to insurance risk *(continued)*

Risk management *(continued)*

Short-term insurance underwriting risk (continued)

Risk management per short-term insurance product line

Homeowners' comprehensive insurance	Multiple, similar claims make claim rates more predictable in normal circumstances. Assessment and adjustment of potential claims is undertaken. Cover is included in the catastrophe reinsurance purchase.
Personal lines, accident and travel insurance	Scientific pricing using multiple risk factors is used in risk selection and to charge premiums matched to underlying risk. Assessment and adjustment of potential claims is undertaken. Cover is included in the catastrophe reinsurance purchase.
Commercial insurance for small, medium and large companies	In underwriting these risks, significant focus is placed on the quality of fire protection and other risk measures. Assessment and adjustment of potential claims is undertaken. Catastrophe reinsurance is purchased to protect against natural catastrophes, in particular earthquakes, and against large individual losses.
Agricultural insurance	Diversification is sought across crops, seasons and geographical regions. Stop loss reinsurance is in place to protect against excessive claims. Risks are individually underwritten before being taken on. Constant assessment of crop development and adjustment of potential claims is undertaken.
Specialist lines	Risks underwritten by underwriting management agencies are only undertaken with specialists in their respective areas with track records of underwriting and claims control. Reinsurance for relevant risks is included in the main or specific reinsurance treaties.

Life insurance underwriting risk

The number of risks falling outside the ambit of standard underwriting mandates is reviewed on a regular basis to determine whether underwriting rules need to be tightened and/or risk parameters extended. The business relies on annual experience investigations, ongoing demographic studies and analyses of surplus to set pricing and valuation parameters. The non-economic pricing and reserving assumptions (i.e. mortality, morbidity, persistency and expense assumptions) are revised to be in line with changes in trends that are likely to continue in the future. The table below summarises risk management measures implemented per life insurance product line.

Risk management per life insurance product line

Mortgage protection and complex underwritten life business	The main risks are mortality and morbidity. This is the only business that is individually underwritten at the application stage. Premium rates differentiate by gender, age, smoker status, socio-economic class and occupation. Sub-standard risks generally receive additional premium loadings or are declined. Correct pricing and effective underwriting control the mortality and morbidity risks. Exposure in excess of a retention limit for each policy is reinsured to reduce the variability of the claims experience and the exposure to a single life. Most policies have premium guarantee terms that vary from one year (for yearly renewable business) to 25 years (for products that have an investment component attached). For products with an investment component, the overall premium rate is guaranteed; the investment portion is not guaranteed and could be reduced at the discretion of Absa Life. However, when products are priced, it is not the intention to increase premium rates over the policy term. Experience is monitored to confirm actual experience is in line with pricing assumptions.
Funeral business	The main risk is mortality increased by high Aids rates experienced in the target market. The risk is exacerbated by premium rates that are the same irrespective of the age of policyholders since significant changes in the age profile of customers could impact on experience. Limitation of cover for certain pre-existing conditions for defined time periods (generally two years), applies. Strict experience monitoring limits the risk, combined with the contractual right to increase premiums with a three-month notice period. The intention is not to exercise this right, but the Group does have the option to do so. Reinsurance is not utilised, as sums assured per individual life are minor.

Insurance risk

Approach to insurance risk *(continued)*

Risk management *(continued)*

Life insurance underwriting risk (continued)

Risk management per life insurance product line (continued)

Credit life business	The main risks are retrenchment and mortality. Treaty reinsurance arrangements are in place whereby risk is shared with external business partners. The right to change premiums with a 30-day notice period is retained. Premiums generally do not differentiate on the basis of gender, age or smoker status, and demographic shifts could introduce additional insurance risk.
Group life business	The main risk is mortality risk. Treaty reinsurance arrangements are in place whereby risk is shared with external business partners. Contracts and premium rates are reviewed annually. Additional catastrophe reinsurance cover will be considered for an accumulation of losses that may occur due to the geographical concentration of a group.

Life insurance mismatch risk

A mismatch arises if the assets backing non-linked products do not grow sufficiently or materialise timeously to match specified amounts guaranteed on death, disability, critical illness or retrenchments, or on survival to the end of the policy. Mismatch risk is managed through setting asset allocations which appropriately match assets to underlying liabilities. Guaranteed life event benefits and guaranteed maturity benefits are each managed in terms of separate investment strategies. Hedging solutions for the guaranteed maturity benefits are considered quarterly, with the first three quarterly tranches being hedged effective 1 July 2012.

Life and short-term investment risk

Investment risk relates to the variability in the value of life and short-term shareholder assets, and of assets backing policyholder liabilities in respect of short-term insurance. Interest rate risk relates to the change in investment value of assets due to a change in interest rates. Foreign exchange risk is the risk that a change in the exchange rate could affect the financial results of the insurance entity. A portion of the current foreign exchange exposure, in respect of short-term insurance, relates to a United States dollar denominated investment used to hedge the amount payable to a foreign supplier contracted to develop an administration system. Investment risk is mitigated through diversified asset allocations and investment mandates.

Short-term insurance underwriting risk

Reinsurance

The impact of large individual short-term insurance claims is limited through the purchase of reinsurance that limits the risk retained on each claim. The accumulation of net retained exposures due to multiple claims is limited through the purchase of catastrophe reinsurance. Catastrophe reinsurance, particularly related to earthquake risk, is purchased to cover losses of up to R3,0 billion.

Reinsurer credit risk

The credit risk in respect of reinsurance partners is managed by ensuring the entities only transact with reinsurers with good credit ratings. The creditworthiness of reinsurers is regularly monitored. To qualify as a reinsurance partner, reinsurers must be assigned a minimum 'A' rating by the Standard and Poor's (or equivalent) rating agency. Any exceptions to this policy must be approved by management as well as by the various boards of directors of the insurance businesses.

Concentration risk

The primary risk of concentration arises from exposure to personal and commercial business in Pretoria, Johannesburg and the East Rand. These exposures are reduced significantly through reinsurance protection. The maximum expected loss for a one in 250-year event is a loss of R3,0 billion.

Short-term insurance underwriting risk *(continued)*

Outstanding claims reserves

Outstanding claims reserves are held for claims which have been notified but not yet fully settled. Individual estimates are sourced from claims assessors and are reviewed as and when new information regarding a claim becomes available. The claims provision includes the expected claim cost and any associated handling costs. Claims development patterns are regularly monitored to assess trends and to determine the appropriate level of reserving.

Incurred but not reported claims reserves

A stochastic reserving model is applied to calculate the incurred but not reported (IBNR) claim provision for the majority of the exposures. Where detailed data is not available, the provision is based on interim measures proposed by the Financial Services Board.

Sensitivity analysis

The IBNR provision is determined by taking the following factors, per class of business underwritten, into account:

- actual and expected claims experience;
- actual and expected reporting patterns; and
- premium volumes.

These factors affect the sensitivity of the IBNR and are taken into account in setting the level of reserves required.

Changes in assumptions

The IBNR and outstanding claims provisions take historical data, trends and recent experience in claims processing and loss ratios into account. These calculations, together with changes in the underlying risk profile of the business, impact the determination of the final balances.

Life insurance underwriting risk

Reinsurance

A formal reinsurance policy has been approved by Absa Life’s board of directors. Reinsurance is used in respect of large individual risks and in respect of risks where Absa Life needs to build knowledge and experience as well as obtain technical assistance from the reinsurers. Catastrophe reinsurance is used as a protection against a large number of simultaneous losses.

Reinsurer

Reinsurer credit risk is managed by transacting solely with reinsurers in possession of international ‘A’ credit ratings as well as by holding capital in line with or in excess of regulatory requirements.

The individual ratings of the various reinsurers, knowledge of disputes and collection experience are used to determine whether the reinsurance assets should be impaired. The reinsurance assets were unimpaired at the reporting date as none of the reinsurance amounts receivable were past due.

Concentration risk

The risk of several claims arising simultaneously (‘concentration risk’) on individual lives is small. The size of individual policies is low, and reinsurance is used to cover larger individual exposures.

In the case of the group life business, there is greater risk of geographic concentration since groups of lives, particularly per employer, are insured. In addition to comprehensive quota share reinsurance, catastrophe reinsurance is used to provide protection against an accumulation of losses in respect of risk retained.

Insurance risk

Life insurance underwriting risk *(continued)*

Mortality and morbidity risk

The business uses experienced underwriters to review risk cover applications in excess of specified limits and evaluate them against established standards. Human Immunodeficiency Virus (HIV) testing is carried out in all instances where the application exceeds the specified limits. Where an applicant requires cover in excess of specified monetary or impairment limits, the excess is reinsured. Mortality and morbidity risks are managed per product line based on underwriting criteria, pricing, reinsurance and experience.

HIV and Aids risk

Absa Life is exposed to HIV and Aids risk where an insufficient allowance has been made in the pricing and valuation bases. To manage risk for the business that is medically underwritten, HIV tests are performed as part of the normal underwriting process. Cover is not provided in instances where the mortality risk is uncertain or is deemed to be too high. For other lines of business, such as funeral and credit life, general pre-existing condition clauses are included in the contract to protect against anti-selection by policyholders. In such an event, a claim will not be paid if it occurs as a result of a condition existing at the inception of the policy or within a certain period (generally 24 months) from inception.

Aids mortality investigations are performed. The results of these investigations assist in setting the premium and mortality basis for life policies. Additional allowances are included in the valuation basis to allow for a worse than expected Aids risk experience.

Lapse risk

Lapse risk is the risk of not recouping expenses such as commission and/or underwriting costs generally incurred at the inception of the policy. In such instances, a loss is incurred if the policy lapses before the costs have been recouped. This risk is managed by entering into 'claw-back' arrangements with financial advisers, whereby the commission or underwriting cost is recouped. Annual investigations of lapse experience are done to ensure Absa's pricing and valuation assumptions are appropriate, relevant and in line with experience.

Expense risk

An allowance for future maintenance and claim expenses, inflated at the assumed expense inflation rate, is included in liability calculations based on the current level of maintenance and claim expenses per policy. The risk of understating and pricing insufficiently for this risk is managed by:

- conducting annual expense investigations based on the most recent operating expenditure incurred;
- monitoring costs on a monthly basis to ensure they remain within anticipated levels and identifying trends at an early stage; and
- basing the assumed future inflation rate on observable economic indicators and experience.

Model risk

Model risk is the risk of determining expected future cash flows and liabilities from existing policies using modelling techniques or methodologies that may be incorrect or inappropriate for certain classes of business. This risk is managed by placing the models through rigorous checking procedures to ensure the cash flows projected by the models are reasonable. Experienced and approved external consultants are used in this process. The modelling methodologies used are in line with guidance issued by the Actuarial Society of South Africa (ASSA) or, in the absence of such guidance, generally accepted actuarial methods.

Data risk

Data risk is the risk that the policy data used to model the liabilities is incorrect or incomplete. This risk is managed by conducting reasonability checks on data and by reconciling the data with the previous valuation data (i.e. a movement analysis) and the financial statements. A new and improved administration system is in the process of being implemented for Absa Life to further mitigate data risk.

Life insurance underwriting risk *(continued)*

Assumption risk

Assumption risk is the risk that the change and effect of the assumptions used in the most recent valuation are not considered. Best estimate assumptions are derived from annual investigations into the demographic experience of the business and economic assumptions are based on observable, actual, consistent economic indicators. Margins are added to best estimate assumptions to allow for variability in the assumptions. These margins include compulsory margins according to the ASSA's Professional Guidance Note 104 and further discretionary margins, where considered necessary by the statutory actuary.

The risk discount rate used to discount future profits includes a margin over assumed investment returns to allow for the risk that experience in future years may differ from assumptions.

Additional allowances are incorporated into the liabilities to mitigate assumption risk. The compulsory margins prescribed in the ASSA's Professional Guidance Note 104 have been applied in the valuation of liabilities.

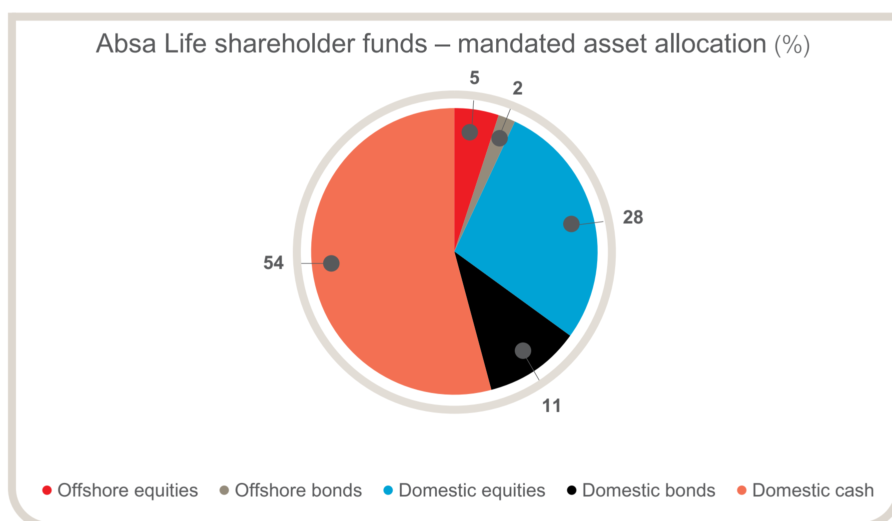
Life insurance mismatch risk

Through the use of asset-liability modelling, appropriate investment strategies for the assets backing policyholder liabilities are determined to mitigate mismatch risk as far as possible. These investment strategies are reviewed at least every second year. For guaranteed mortality, morbidity and retrenchment benefits, an asset allocation, comprising cash and bonds of various terms to maturity, is used. For guaranteed maturity benefits, cash, long-dated bonds and a derivative hedging programme are used. Monthly meetings are held with the asset manager to monitor these asset durations and targeted levels.

Life and short-term investment risk

A single investment strategy is maintained for short-term insurance shareholder assets and for assets backing short-term insurance policyholder liabilities. Assets are invested in short dated interest-earning assets and preference shares. The duration of interest-earning assets is monitored against a maximum effective duration.

The Absa Life insurance shareholders' funds are invested in a balanced portfolio. Following a rebalancing of the offshore investment portfolio the current mandated asset allocation is as follows:



Life and short-term investment risk *(continued)*

Domestic assets have a limit on active equity exposures or tracking error taken on by the asset manager versus the underlying equity benchmark.

Counterparty credit risk in respect of investments is managed by investing with a spread of issuers with F1 or F1+ credit ratings.

Liquidity risk is the risk that cash may not be available to pay obligations when due at a reasonable cost. Liquidity risk is managed in the short-term insurance businesses by investing in short dated interest-earning assets, with limits on investments in less liquid assets such as preference shares and corporate bonds. The life insurance businesses are less exposed to liquidity risks due to the low risk of large cumulative claims. Liquidity risk is managed through close management of potential cash outflow in discussion with the asset managers.

Funding Risk

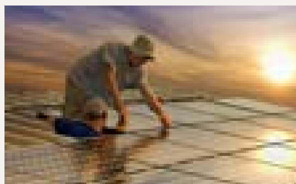
Contents

91 – 112
Funding risk

91 Liquidity risk

99 Capital management

Approach to funding risk.



Liquidity risk

Key points to note

- Maintained and improved strong liquidity position ahead of Basel III.
- Continued high levels of surplus liquid assets held.
- Sustained strong funding tenor position in challenging market conditions.
- Liquidity risk management process remains robust and comprehensive.

Key performance indicators

	30 June		31 December
	2012 %	2011 %	2011 %
Long-term funding ratio	**25,6**	26,8	26,8
Loans-to-deposits ratio	**86,9**	91,0	88,4

Introduction

Liquidity risk is the risk that the Group is unable to meet its payment obligations when they fall due and to replace funds when they are withdrawn, the consequences of which may be the failure to meet obligations to repay depositors and to fulfil commitments to lend. Liquidity risk, more generally, is the risk that the Group will be unable to continue operating as a going concern due to a lack of funding.

Liquidity risk is inherent in all banking operations. Confidence in the organisation, and hence liquidity, can be affected by a range of institution specific and market-wide events including, but not limited to, market rumours, credit events, payment system disruptions, systemic shocks, terrorist attacks and even natural disasters.

The appropriate and efficient management of liquidity risk by banks is of utmost importance in maintaining confidence in financial markets and in ensuring that banks pursue sustainable business models.

Strategy

The Group's liquidity risk management objectives are to:

- grow and diversify the funding base to support asset growth and other strategic initiatives;
- lengthen the Group's funding profile in order to improve key liquidity metrics, thereby reducing the Group's liquidity risk exposure;
- continue to build surplus liquid asset holdings in view of the Basel III liquidity requirements; and
- focus on lowering the weighted average cost of funding within agreed parameters for liquidity risk.

June 2012 in review

Absa's liquidity position remained strong as the Group continued to focus on maintaining its surplus liquid asset reserves, extending its funding term and growing its deposit base. Relatively slow growth in the South African economy meant the supply of liquidity remained strong as banks were not required to lend as much money as in previous periods of strong economic growth. The Group successfully issued senior unsecured debt in March 2012 to further extend its funding term and diversify its funding base. The Group also managed to maintain its position of reduced reliance on wholesale money market funding sources which were built up during 2011. The cost of liquidity remained reasonably stable throughout the reporting period with indications of a gradual increase in liquidity cost. The appetite for term funding in money markets dampened as a result of asset managers having to rebalance the duration profiles of their money market funds.

An amendment made to the Collective Investment Schemes Act has relaxed the average duration restrictions applicable to money market funds from 90 days to 120 days, which should help alleviate the position during the second half of 2012.

Liquidity risk

Looking ahead

Liquidity risk measurement and management continues to receive significant attention worldwide. As outlined previously, regulators have allowed a period of several years for full implementation of the Basel III liquidity rules. Compliance with the LCR, which is aimed at promoting the short-term resilience of a bank's liquidity risk profile, is required by January 2015, whereas compliance with the NSFR, which is aimed at promoting resilience over a longer time horizon (one year), is required by January 2018. The Group will continue to focus on liquidity risk to maintain and continuously improve its strong liquidity risk position ahead of Basel III and to ensure full compliance within the required timeframes.

Approach to liquidity risk

Group Treasury is responsible for implementing the liquidity risk framework and policy and for ensuring that liquidity risk is adequately managed across the Group. Group Treasury also monitors and manages the Group's liquidity position to ensure full regulatory compliance in respect of liquidity risk management and reporting. As part of this process, Group Treasury takes the contractual and business-as-usual (behavioural adjusted) liquidity positions, as well as the stress tested liquidity position into consideration.

Business-as-usual liquidity risk management

Business-as-usual liquidity risk management refers to the management of the cash inflows and outflows of the bank in the ordinary course of business. The business-as-usual environment tends to display fairly high probability, low severity liquidity events and involves balancing the Group's day-to-day cash needs. Group Treasury's approach to managing business-as-usual liquidity focuses on the following key areas:

- managing net anticipated cash flows (between assets and liabilities), within approved cash outflow limits;
- active daily management of the funding and liquidity profile taking the board-approved liquidity risk metrics into consideration. These metrics were designed to ensure compliance with the Group's business-as-usual liquidity risk tolerance and to position the Group to deal with stressed liquidity events;
- maintaining a portfolio of highly liquid assets as a buffer against any unforeseen interruption to cash flow;
- participating in local money and capital markets to support the day-to-day funding requirements such as refinancing maturities, meeting customer withdrawals and supporting growth in advances;
- monitoring and managing liquidity costs; and
- conducting an ongoing assessment of the various funding sources in order to grow and diversify the Group's funding base and achieve an optimal funding profile.

Key risk metrics used in business-as-usual liquidity management

Risk metric	Purpose of metric
Short-, medium- and long-term funding ratios	Provides a measure of the contractual term of the funding used. For example, the long-term funding ratio shows the proportion of total funding that has a remaining contractual term in excess of six months.
Interbank funding ratio	Provides an indication of the extent to which reliance is placed on funding from other banks.
Short-term maturity cash flow mismatches (at a contractual and behavioural level)	Provides a measure of the extent to which cash flow mismatches occur in the short term (i.e. less than one month).
Cash outflow limits	Measures expected cash outflows against predetermined limits.
Concentration of deposits	Provides a measure of the extent to which reliance is placed on funding from certain customers or market sectors.

Stress liquidity risk management

Stress liquidity risk management refers to the management of liquidity risk during times of unexpected outflows arising from Group specific or systemic stress events. Group Treasury regularly performs liquidity scenario analyses and stress tests to assess the adequacy of the Group's stress funding sources, liquidity buffers and contingency funding strategies in the event of such a stressed scenario. Scenario analysis and stress testing encompasses a range of realistic adverse events which, while remote, could have a material impact on the liquidity of the Group's operations.

Through scenario analysis and stress testing, the Group aims to manage and mitigate liquidity risk by:

- Determining, evaluating and testing the impact of adverse liquidity scenarios.
- Identifying appropriate rapid and effective responses to a crisis.
- Setting liquidity limits, sources of stress funding and liquidity buffers as well as formulating a funding strategy designed to minimise liquidity risk.

The Group's overall objective is to ensure that during a liquidity stress event, the Group's stress funding sources and liquidity buffers exceed the estimated stress funding requirements for a period of at least 30 days. Stress testing and scenario analysis is used to evaluate the efficiency of identified sources of stress funding along a continuum of risk scenarios and to formulate and test contingency plans.

Approach to liquidity risk *(continued)*

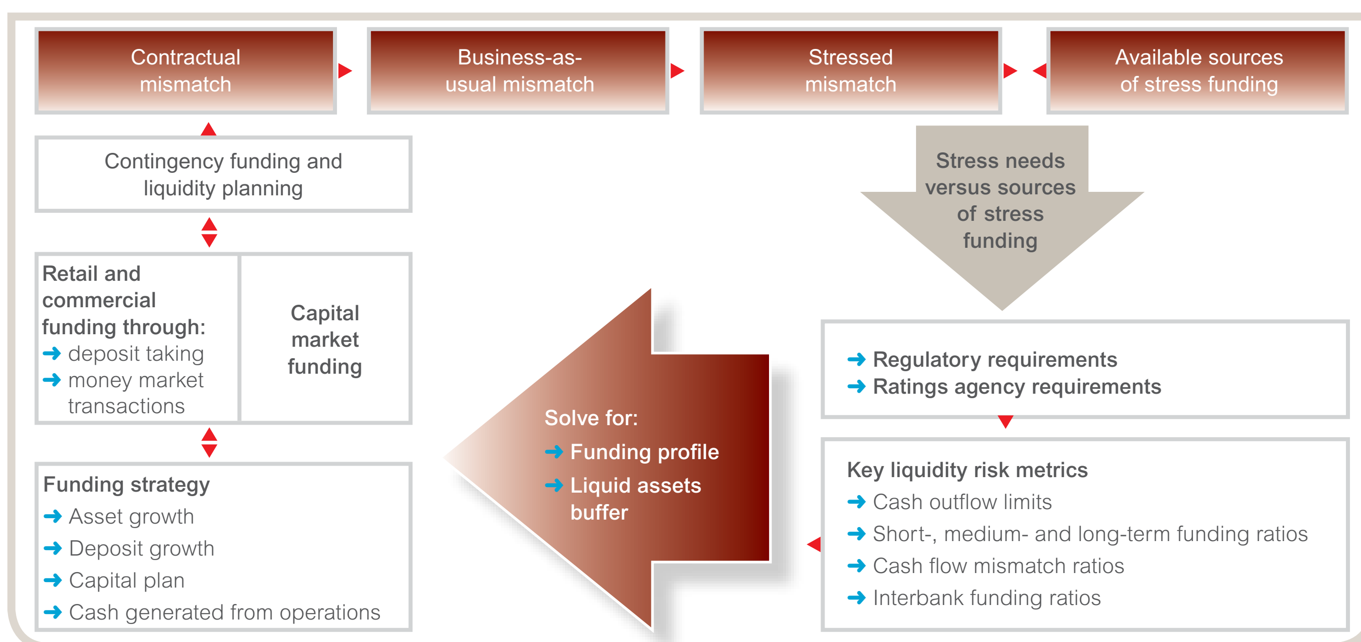
Stress liquidity risk management *(continued)*

A detailed contingent funding and liquidity plan (CFLP) has been designed to protect depositors, creditors and shareholders during adverse liquidity conditions. The plan includes early warning indicators and sets out the crisis response strategy addressing sources of stress funding, strategies for crisis avoidance/minimisation and the internal and external communication strategy. Liquidity simulation exercises are conducted regularly to test the robustness of the plan and to ensure that key stakeholders remain up to date on liquidity matters. A successful simulation exercise was completed during the second half of 2011.

Key risk metric used in stress liquidity risk management

Risk metric	Purpose of metric
Survival horizon	Provides a measure of the adequacy of the bank's liquidity resources during times of severe stress, measured as the number of days that the bank is expected to survive a defined liquidity scenario.

The liquidity risk management approach of the Group is summarised in the diagram below:



Regulatory changes in 2012

The National Treasury set up a task team to find ways in which the structural shortcomings of the South African economy could be improved in order to assist banks in complying with the Basel III liquidity rules. These rules require banks to have substantially more liquidity reserves and substantially longer funding terms, (both of which are in short supply in South Africa). The task team has completed its mandate. Absa was an active participant in the initiative and the result of this will be used to inform regulatory policy and direction as it relates to the financial services sector in South Africa. In May 2012, the SARB announced it had approved a committed liquidity facility to assist banks in meeting the LCR under Basel III. It was further confirmed that statutory cash reserves may be included in the calculation of the LCR. Conditions were set by the SARB regarding the size of the committed facility, and collateral and pricing were set by the SARB. The availability of a liquidity facility means banks could potentially hold less liquid assets and still comply with the requirements of the Basel III LCR, which would hold potential benefits for local banks and the broader economy. Funding that would otherwise have to be deployed to build liquidity buffers can now be used to extend loans to customers, thereby helping to grow the economy. Compliance with the two key liquidity Basel ratios is required from 2015 and 2018, respectively.

Key metrics under Basel liquidity risk framework and timeframes for compliance

Risk metric	Purpose of metric	Compliance required by
LCR	To promote short-term resilience of a bank's liquidity risk profile by ensuring it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month.	2015
Net stable funding ratio (NSFR)	To promote resilience over a longer time horizon (one year) by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis.	2018

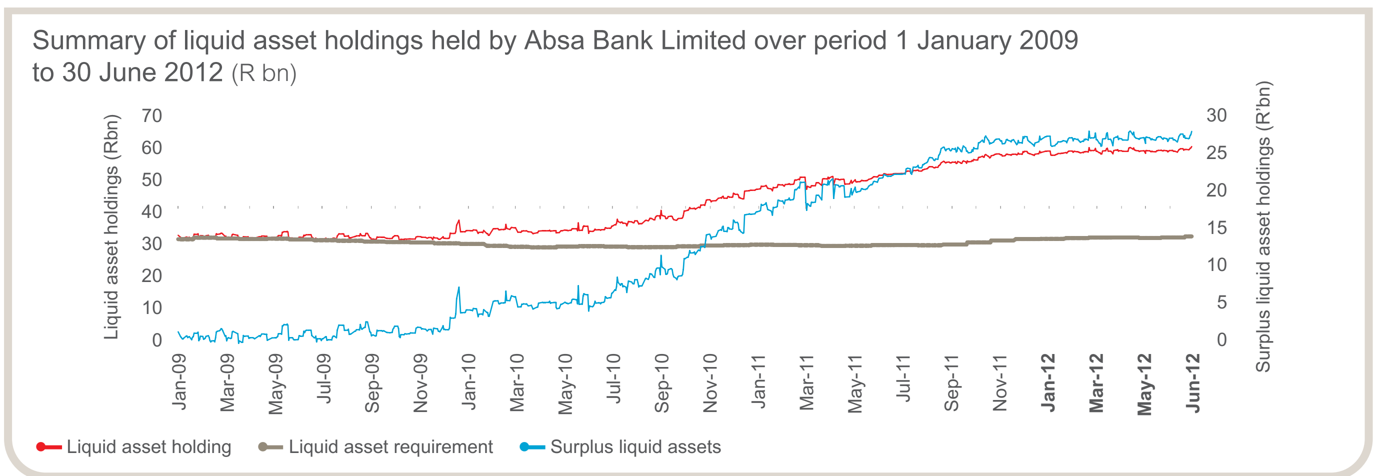
Liquidity risk

Regulatory changes in 2012 *(continued)*

The Group maintained its strong liquid assets buffer and the funding tenor position of its wholesale funding book, ahead of the timeframes required by the Basel rules outlined in the previous table. Liquidity resources remain sufficient under the liquidity risk appetite framework with surplus liquid assets under a one-month survival horizon. The Group is currently evaluating the most optimal approach to follow in order to comply with the Basel LCR. This is likely to be based on a combination of liquidity buffers and the utilisation of the committed facility made available by the SARB. Further information on progress made and on the plans for 2012 can be found in the sections that follow.

Surplus liquid assets held

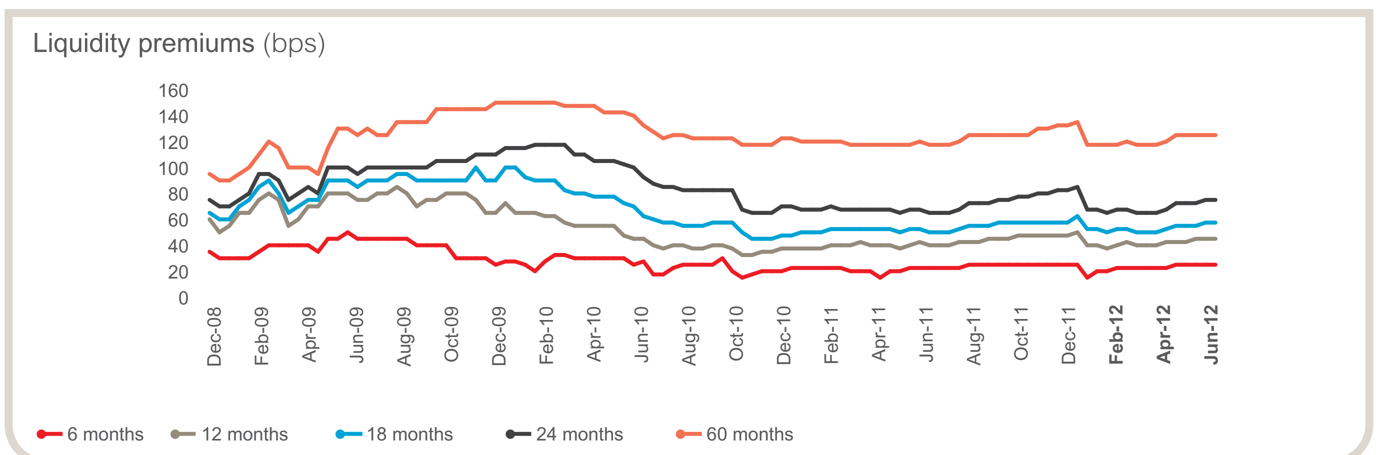
The level of surplus liquid assets held by Absa (defined as unencumbered liquid assets held in excess of the amount required to be held in accordance with the regulations) has been maintained at the strong level of R27 billion during the reporting period.



Cost of liquidity

The cost of maintaining the liquidity pool (consisting of liquid assets held to comply with regulatory requirements, plus surplus liquid assets held over and above the minimum regulatory requirements) is a function of the cost of funding used to purchase the liquid assets compared with the return earned on the liquid assets.

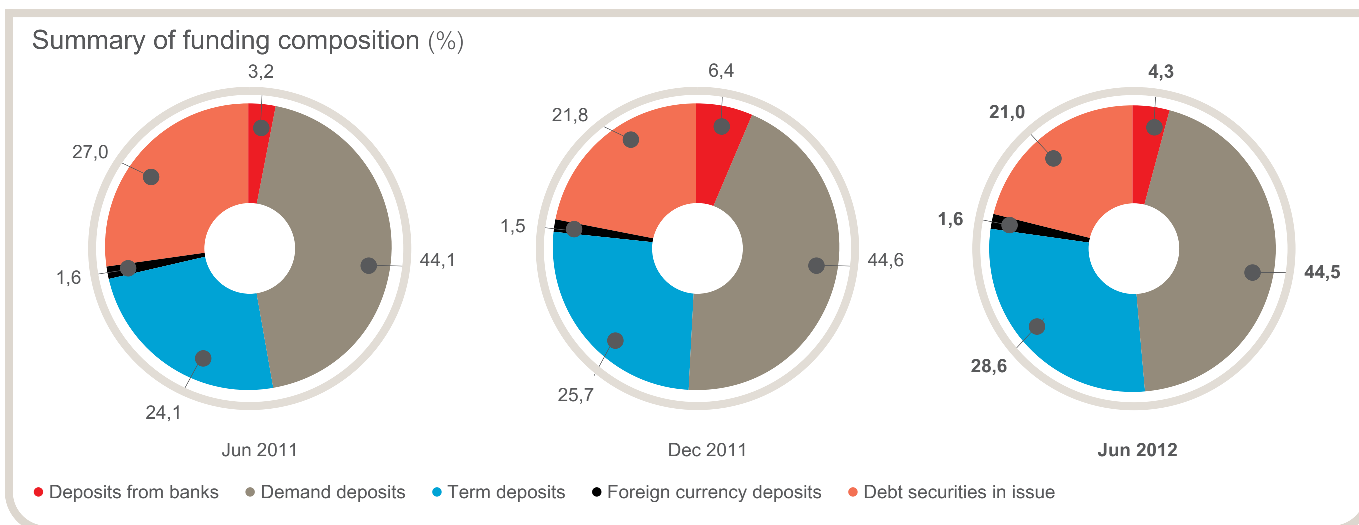
The beginning of 2010 saw liquidity premiums (i.e. the excess return or premium demanded by the market to invest funds with banks for longer periods than overnight) at historically high levels. As an example, the liquidity premium for 12-month funding was as high as 80 bps at the beginning of 2010. The graph below indicates that liquidity premiums remained high for most of 2011, with increases evident during the first half of 2012.



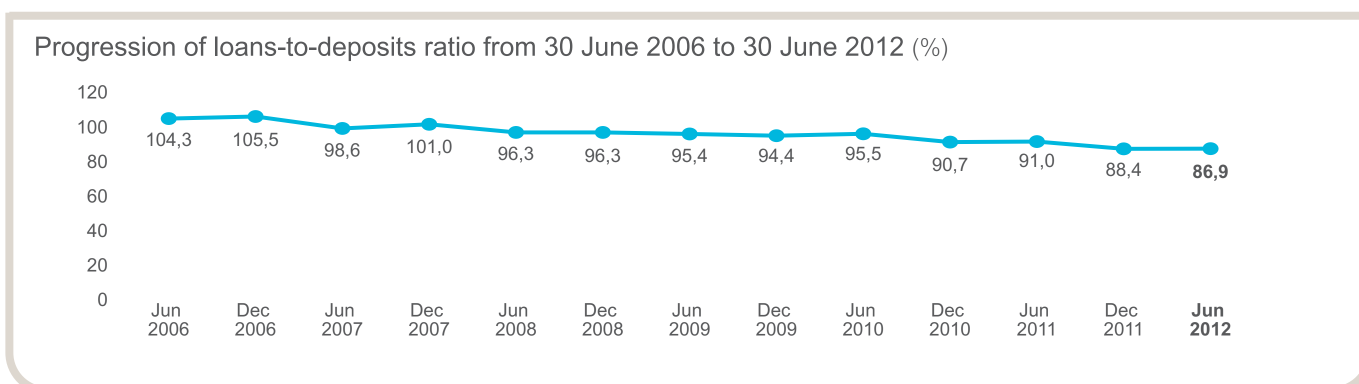
Funding structure

The funding position of the Group remained strong during the reporting period due to maintained strong positions in growth deposits combined with selective asset growth. Retail Markets remains partly funded by retail deposits, while the corporate business remained self-funded during the reporting period. The Group relies on wholesale funding markets for the balance of funding required. CIBW acts as the Group's face to the market for obtaining wholesale funding.

Funding is sourced from a variety of depositors representing a diversity of South African economic sectors with a wide range of maturities. The Group has a well diversified deposit base and concentration risk is managed within appropriate guidelines. Sources of liquidity are regularly reviewed to maintain a wide diversity of provider, product and term.



The progression of the loans-to-deposits ratio of the Group is summarised in the following graph. The ratio has improved during the period, as a result of continued focus on asset quality and prudent liquidity risk management practices.



Funding structure *(continued)*

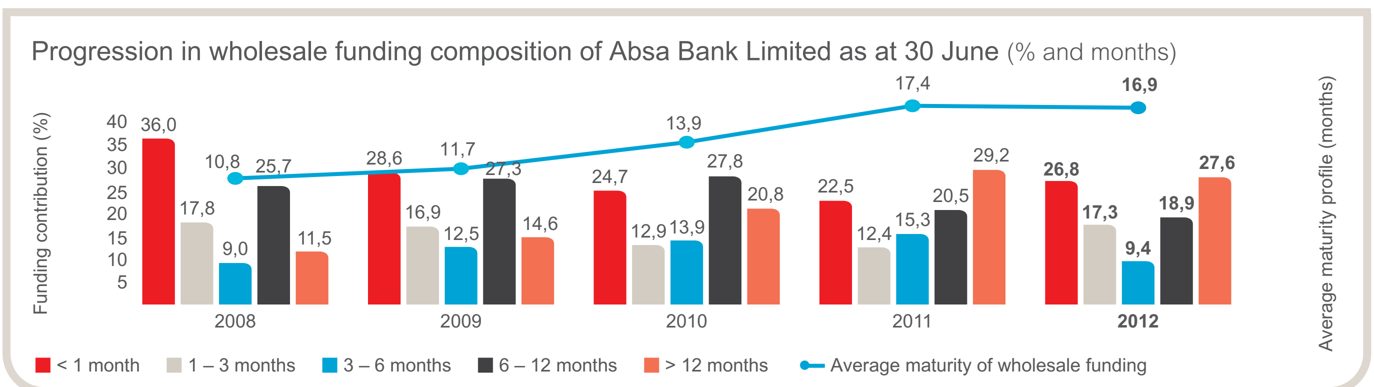
A more detailed breakdown of the loans-to-deposits ratio for the Group is provided below:

	30 June		31 December
	2012	2011	2011
Advances (Rm)			
Loans and advances to customers	**506 661**	504 199	504 924
Deposits (Rm)			
Deposits due to customers	**457 880**	405 673	440 960
Debt securities in issue	**125 127**	148 468	130 262
	583 007	554 141	571 222
Ratio (%)	**86,9**	91,0	88,4

Lengthening the funding profile of the Group's funding base is a key strategic aim. Despite structural constraints in the South African economy which limit the extent to which South African banks are able to lengthen their funding profiles, the Group was able to maintain its strong funding term position.

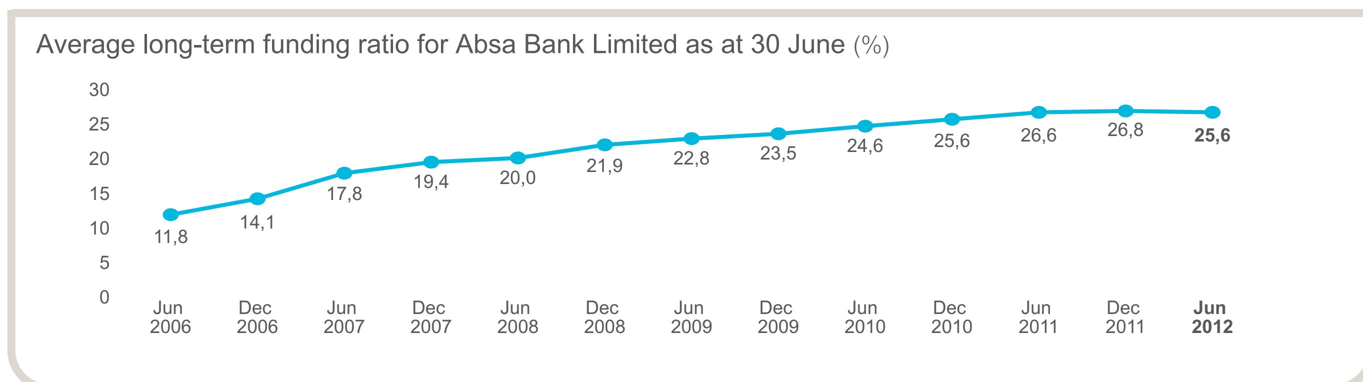
The graph below summarises the extent to which the Group has been able to extend its wholesale funding profile since 30 June 2008. The weighted average remaining term of wholesale funding has increased from approximately 11 months at 30 June 2008 to approximately 17 months at the reporting date.

A key metric used to track the funding structure of the Group is the long-term funding ratio. This ratio reflects the proportion of total funding with an outstanding term in excess of six months.



Funding structure *(continued)*

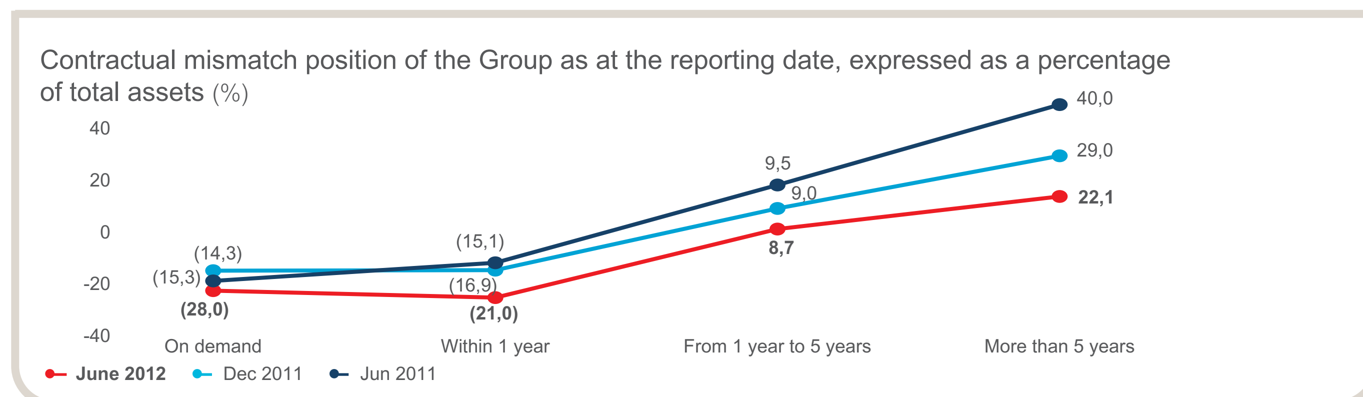
The positive progression in Absa's long-term funding ratio is depicted in the following graph.



Capital markets funding is also used to extend the funding term of the Group. R6 billion of term funding was issued by the Group during the first half of the year 2012.

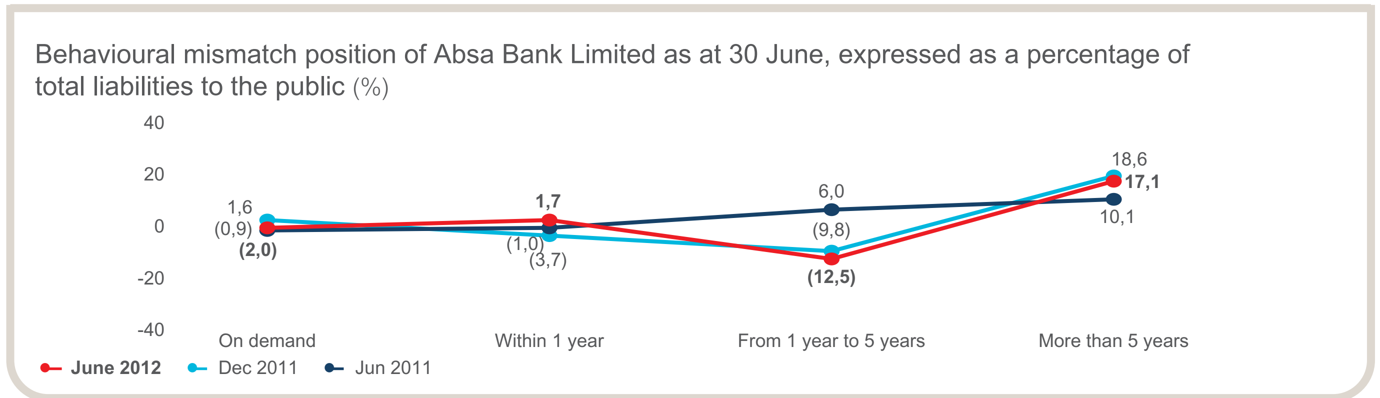
Contractual and behavioural liquidity mismatch positions

The graph below summarises the Group's contractual mismatch position. The contractual mismatch position over five years improved during the reporting period as a result of prudent liquidity management practices and a further extension in funding term which was achieved by increased capital markets issuance during the first quarter of 2012, improved product mix and a continued focus on securing longer-dated money markets funding.



Liquidity risk

Contractual and behavioural liquidity mismatch positions *(continued)*



Stress and scenario testing

Further steps were taken during the reporting period to reduce reliance on unsecured funding sources and to increase surplus liquid assets. As part of stress and scenario testing, the Group's liquid assets portfolio serves as the main source of liquidity under stress. Liquidity value is also assigned to unsecured funding lines, readily marketable investment securities held and price sensitive overnight loans.

Further progress was made on assessing liquidity risk and formulating the Group's liquidity risk appetite (measured as the number of days that the Group is expected to survive a defined liquidity stress scenario). The Group continues to hold sufficient liquidity resources to meet the Group's liquidity risk appetite, which is to be able to survive a severe liquidity stress for a minimum period of 30 days. Management will continue to focus on liquidity risk management within the Group and on the implementation of Basel III, during the remainder of 2012.

Other funding risks

Per the PRP, structural risk is also reported under funding risk. Structural risk relate to the management of non-contractual risks and predominantly arises from impact on the Group's balance sheet of changes in primarily interest rates on income or foreign exchange rates on capital ratios.

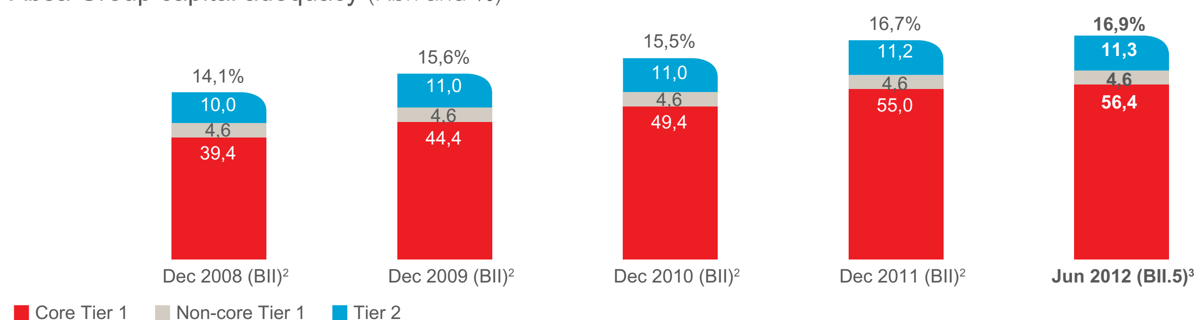
Key points to note

- Strong capital position maintained above board-approved target ranges.
- Successful implementation of the AIRB approach on the wholesale portfolio and Basel II.5 with minimal impact on Core Tier 1.
- Optimal mix of capital remains a key priority.
- Continued focus on net generation of equity and risk-weighted assets optimisation.
- Industry-wide discussion with the SARB on pending Basel III regulatory changes continues, in order to clarify uncertainty from a South African perspective. Areas requiring clarification include elements of capital supply, capital demand and capital buffers.

Key performance indicators

Group[1]	30 June 2012	31 December 2011	31 December 2011	Minimum regulatory capital requirements	Board target ranges 2012
Capital adequacy (%)					
Core Tier 1	**13,2**	12,8	13,0	**5,25**	**9,5 – 11,0**
Tier 1	**14,3**	13,9	14,1	**7,00**	**n/a**
Total	**16,9**	16,7	16,7	**9,50**	**12,5 – 14,0**
Capital supply and demand (Rm)					
Free cash flow generated	**1 526**	3 762	3 614		
Qualifying capital	**72 261**	68 169	70 780		
Total risk-weighted assets	**426 452**	408 397	424 489		
Key metrics (%)					
Cost of equity[4]	**13,5**	14,0	14,0		
Return on average risk-weighted assets (RoRWA)	**2,08**	2,23	2,35		
Return on average economic capital (RoEC)	**20,8**	22,4	23,0		

Absa Group capital adequacy (Rbn and %)[1]



Notes

[1]Reported ratios include unappropriated profits.

[2]BII: Basel II.

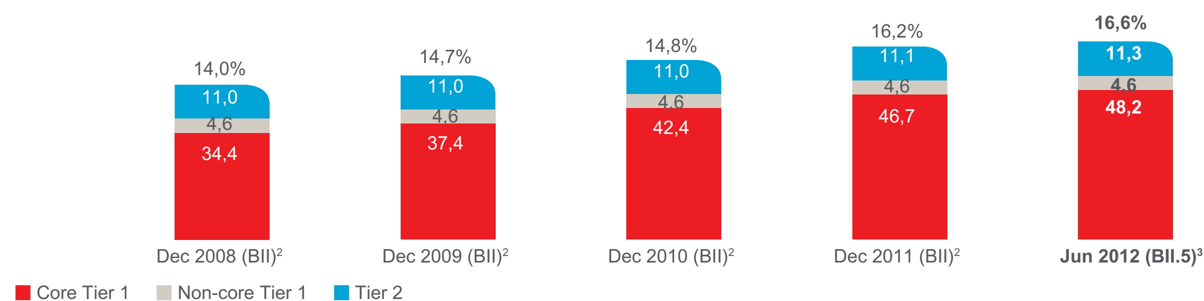
[3]BII.5: Basel II.5.

[4]The average cost of equity is based on the Capital Asset Pricing Model (CAPM).

Key performance indicators *(continued)*

Bank[1]	30 June 2012	31 December 2011	31 December 2011	Minimum regulatory capital requirements	Board target ranges 2012
Capital adequacy (%)					
Core Tier 1	**12,5**	11,8	12,1	**5,25**	**9,0 – 10,5**
Tier 1	**13,7**	13,0	13,3	**7,00**	**n/a**
Total	**16,6**	16,0	16,2	**9,50**	**12,0 – 13,5**
Capital supply and demand (Rm)					
Free cash flow generated	**2 045**	3 724	4 686		
Qualifying capital	**64 076**	59 954	62 449		
Total risk-weighted assets	**386 490**	373 785	384 933		
Key metrics (%)					
Cost of equity[4]	**13,5**	14,0	14,0		

Absa Bank capital adequacy (Rbn and %)[1]



Notes

[1]Reported ratios include unappropriated profits.

[2]BII: Basel II.

[3]BII.5: Basel II.5.

[4]The average cost of equity is based on the Capital Asset Pricing Model (CAPM). This metric changed during the current reporting period.

Capital management

Introduction

Capital management is a key focus area of the Group. The Group's capital management strategy is to maximise shareholder value by optimising the level and mix of capital resources. Decisions on allocating capital resources are based on a number of factors including RoEC and return of risk weighted assets (RoRWA), and are part of the internal capital adequacy assessment process (ICAAP).

Proactive risk and capital management is key to balance sheet optimisation, one of the four strategic pillars supporting the One Absa strategy. The Group continues to monitor and respond pragmatically to market conditions both locally and internationally, while preparing for the forthcoming Basel III legislative environment. In doing so, the Group will ensure adequate capital is available to support future asset growth.

Capital levels remain well above board-approved target ranges for both the Group and the Bank, with Core Tier 1 capital levels improving by 20 and 40 bps respectively. Proactive capital management, including RWA optimisation and equity generation, remains a priority while further improvements in risk management are implemented. The potential impact of proposed regulatory changes are analysed and steps are taken to integrate necessary changes into the business.

The Basel III framework, released in December 2010 and Draft 1 of the Regulations released during March 2012 by the SARB, is expected to have a significant effect on the global and local banking industry. The framework introduces new and more stringent capital and liquidity requirements which are expected to be phased in over a number of years. However, the application of Basel III to South Africa and local discretionary items still need to be determined and the Group is actively engaging with the SARB to obtain more clarity. The Group deems it prudent to maintain higher capital levels in the interim. The Group is also participating in the Basel Committee on Banking Supervision's Quantitative Impact Studies (QIS) as well as industry discussions held at the Banking Association of South Africa (BASA), to enable it to assess and provide feedback on the expected impact of the new rules. The Group will continue to review its capital position and implement appropriate management action, when necessary, to ensure it remains adequately capitalised at all times. Further detail on Basel III and the Group's response are set out further on in this section.

Strategy

The Group's capital management objectives are to:

- meet the capital ratios required by regulators and the target ranges (stress buffers over regulatory minimum) approved by the board;
- maintain an adequate level of available capital resources as cover for the economic capital (EC) requirements, calculated at a 99,95% in line with risk appetite;
- deliver RWA efficiency, capital and balance sheet accountability and returns;
- maintain an investment grade credit rating; and
- assess the potential impact of Basel III on the capital position and implement appropriate management actions if deemed necessary.

June 2012 in review

The Group maintained its strong capital adequacy position, increasing its Core Tier 1 ratio and thereby further improving the quality of capital. Key focus areas included:

- Improving capital adequacy levels – for the reporting period under review the Group maintained a strong capital adequacy position, placing it in a healthy position to deal with the implementation of Basel III changes; freeing up of capital through RWA optimisation – which lowers the potential need to raise additional capital in the future, both for Basel III and growth.
- Improving understanding of risk – many RWA optimisation exercises focused on improving data quality and improving model accuracy, resulting in a more accurate measurement of risk. The importance of risk sensitive capital allocation, together with the metrics used to measure business performance, allows the Group to allocate capital on a more accurate risk-vs-return basis.
- Ensuring capital models were updated to reflect the current environment.
- Successful implementation of Basel II.5 and AIRB for the wholesale credit portfolio; and
- RWA optimisation.

Looking ahead

Capital management is a key focus area of the Group. The Group's strategic focus for 2012 is to maintain a strong level, high quality and optimal mix of capital, while continuing to generate sufficient capital to support economically profitable asset growth and the active management of the business portfolio. In addition, the Group intends to further optimise the use of capital without jeopardising the Group's ability to comply with expected Basel III regulatory changes. As in 2011, RWA optimisation remains a key focus area of the Group.

Capital management

Approach to capital management

The Group plans and manages its capital to ensure it has sufficient and appropriate capital structures to support its risk appetite and business activities, as well as credit rating and regulatory requirements.

The capital management framework adopted by the Group provides the basis for effective capital planning and structuring, capital issuance, Basel alignment, EC utilisation and economic profit. It provides end-to-end integration of the Group's strategy, risk management and financial processes. The purpose of the framework is to ensure capital consumption in the BUs has an impact on performance measurement, which in turn translates into management performance assessment, product pricing requirements and the achievement of the Group's desired strategic positioning.

ICAAP

The ICAAP and its underlying components form an integral part of the Absa Group's decision making and business processes. The Group has embedded risk and capital management tools, processes and activities across its clusters to actively influence management behaviour to align with the Group's risk strategy.

At its most strategic level the ICAAP is used to inform the board of the ongoing assessment of the Absa Group's risks, how the risks are mitigated and how much current and future capital is considered necessary taking into account mitigating factors.

The ICAAP is used to ensure that the board's risk appetite and minimum capital ratios can be maintained over the period of the medium term plan (MTP), having been subjected to suitably severe stress and scenario analysis. Stress testing is conducted annually to identify market condition changes that could adversely impact the Group in order to identify management actions to mitigate risks on a timely basis.

Furthermore, it ensures that the internal systems, controls and management information are in place to enable the board and senior management to track changes in the economic/financial environment, which may require adjustments to the business strategy to remain within the risk appetite, on an ongoing basis.

The efficient use of capital is fundamental to ensuring a clear focus on enhancing shareholder value through the careful deployment of capital resources.

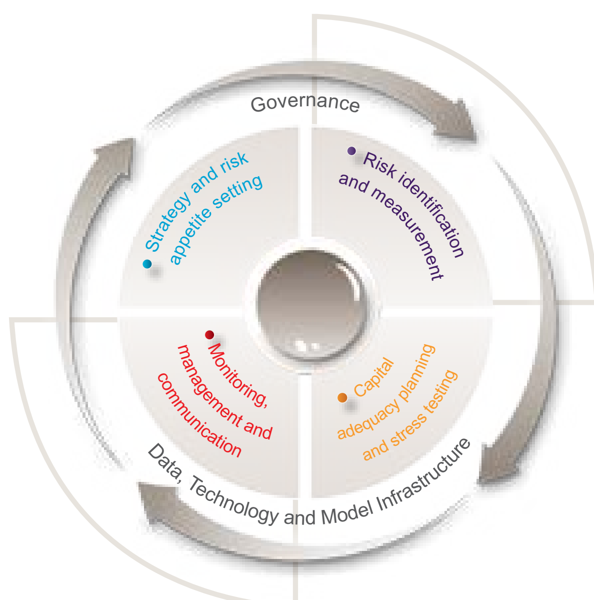
The Group has adopted a building block approach to achieve a robust and integrated capital management framework. The ICAAP is an important element of strategy development and implementation, as is evidenced by the link between the building blocks such as financial forecasting, risk appetite setting, stress testing and capital planning.

EC is the framework used to set internal capital demand and supply and is means by which the Group assesses the impact of a changing business environment and strategy on its risk profile and the need for capital. EC is a measure of capital required to maintain or achieve a target investment grade credit rating. Absa targets a capital level equivalent to an AA rating.

Aside from its application in capital management, EC is a key component of Group level and BU level applications such as capital management, stakeholder communication, risk-adjusted performance measurement, pricing and structuring.

While the ICAAP is intended to align with regulatory requirements under Pillar 1 and Pillar 2 of regulatory framework, the main guiding principle in designing the ICAAP for the Group has been suitability for capital management and other internal applications. The Group considers its ICAAP to be in line with international best practice and is of the opinion that it addresses the core banking principles of Pillar 2 of Basel II.

The building blocks of the Group's ICAAP are as follows:



Approach to capital management *(continued)*

ICAAP *(continued)*

These processes are conducted within an environment with established governance practices and oversight and are supported by adequate data, technology expertise and model infrastructure.

Stress testing is performed to identify early warning thresholds and risk events that may adversely impact the Group's risk profile, as well to test the robustness of capital. Stress testing is also used to determine adequate capital buffers that are considered sufficient to ensure that both the Group and the Bank do not breach the minimum regulatory ratios under stress scenarios and to formulate appropriate management actions. From an ICAAP perspective, stress testing represents the link between risk management and capital management. As a result of better risk management practices and also driven by global events, stress testing has become increasingly important in assessing appropriate levels of capital to ensure the ability to absorb stress events in order to protect our depositors and other stakeholders.

Basel III

The Basel III framework will be phased in from 1 January 2013 and focuses on the following areas:

- Stringent new liquidity requirements through the creation of two ratios: liquidity coverage ratio and net stable funding ratio;
- Higher and better quality capital, including the creation of capital conservation and countercyclical buffers;
- Improved trading risk coverage; and
- Leverage caps with a minimum of 3% internationally versus a proposed 4% by SARB.

Although uncertainties still exists on certain elements of Basel III from a South African perspective, the Group is expected to remain adequately capitalised after the implementation of Basel III. The Group is participating in industry-wide discussions with the SARB on pending Basel III regulatory changes in order to clarify uncertainties, including elements of capital supply, capital demand and capital buffers. The Group has deemed it prudent to maintain higher capital levels until clarity is obtained.

The Basel Committee on Bank Supervision (BCBS) continues to monitor the potential impact of Basel III via Quantitative Impact Studies (QIS) being conducted by local regulators worldwide. The Group participates in the OIS, which covers liquidity, capital and leverage, on a six monthly basis.

The Group will continue to review its capital position in light of the Basel lll rules and will implement appropriate management actions if and when deemed necessary.

Capital requirements

The Group manages its capital in accordance with the minimum regulatory requirements, EC requirements and the target ranges approved by the board, as follows:

- Regulatory requirements: net qualifying capital (Tier 1 plus Tier 2 capital) must sufficiently exceed Basel III requirements to provide a buffer for prudence.
- Economic requirements: available capital resources must be sufficient to meet EC requirements over a three-year period.
- In accordance with board-approved target ranges: which are derived from the stress testing results, and are set above the minimum regulatory requirements.

Capital adequacy

The Group sets target capital ranges/levels for regulated entities (as set out on below) to ensure that the objectives of capital management are met. Appropriate capital management actions are taken if these target ranges/levels are at risk of being breached.

The Group monitors capital adequacy and the use of RC by employing techniques based on the guidelines developed by the Basel Committee on Banking Supervision (BCBS) and implemented by the SARB and other host regulators for supervisory purposes. These techniques include the capital adequacy ratio calculation, which the SARB and other host regulators regard as a key supervisory tool.

Target capital ratios for the Group for the reporting period were set by considering the following:

- the preference of rating agencies for permanent capital stressed scenarios;
- proposed Basel amendments; and
- peer analysis.

Target capital ranges/levels were set for the following regulated entities: Absa Group Limited, Absa Bank Limited, BBM, NBC, Absa Life Limited and Absa Insurance Company Limited. Target capital levels for all other entities were at least equal to the minimum regulatory requirements set by the respective regulators.

Capital management

Capital adequacy *(continued)*

Operations	Regulator	30 June 2012 Total qualifying capital Rm	30 June 2012 Tier 1 ratio %	30 June 2012 Total capital adequacy %	30 June 2011 Total qualifying capital Rm	30 June 2011 Tier 1 ratio %	30 June 2011 Total capital adequacy %	31 December 2011 Total qualifying capital Rm	31 December 2011 Tier 1 ratio %	31 December 2011 Total capital adequacy %
Local entities (South Africa)										
Group	SARB									
Including unappropriated profits		72 261	14,3	16,9	68 169	13,9	16,7	70 780	14,1	16,7
Excluding unappropriated profits		66 531	13,0	15,6	62 808	12,6	15,4	62 489	12,1	14,7
Bank	SARB									
Including unappropriated profits		64 076	13,7	16,6	59 954	13,0	16,0	62 449	13,3	16,2
Excluding unappropriated profits		60 641	12,8	15,7	56 804	12,2	15,2	56 409	11,8	14,7
Foreign banking entities										
BBM[1]	Banco de Mozambique	221	11,2	11,2	315	20,3	20,3	158	8,0	8,0
NBC[1,2]	Bank of Tanzania	630	10,9	10,9	622	13,0	13,0	710	12,6	12,6
Insurance entities										
Absa Life Limited	FSB[3]	1 207	n/a	2,9 x CAR[4]	1 432	n/a	3,6 x CAR[4]	1 198	n/a	2,9 x CAR[4]
Absa Insurance Company Limited	FSB[3]	1 626	n/a	57,3% x NWP[5]	1 537	n/a	54,4% x NWP[5]	1 716	n/a	60,7% x NWP[5]
Absa *idirect* Limited	FSB[3]	128	n/a	117,4% x NWP[5]	96	n/a	87,9% x NWP[5]	114	n/a	97,5% x NWP[5]

Operations	Regulator	Total target capital adequacy ratio Regulatory minimum %	Total target capital adequacy ratio Board target ranges 2012
Local entities (South Africa)			
Absa Group	SARB		
Including unappropriated profits		9,5	12,50 – 14,00
Absa Bank	SARB		
Including unappropriated profits		9,5	12,00 – 13,5
Foreign banking entities			
BBM[2]	Banco de Mozambique	8,0	15,0
NBC[2]	Bank of Tanzania	12,0	14,0
Insurance entities			
Absa Life Limited	FSB[3]	1,0 x CAR[4]	2,0 x CAR[4]
Absa Insurance Company Limited	FSB[3]	28% x NWP[5]	45% x NWP[5,6]
Absa *idirect* Limited	FSB[3]	27% x NWP[5]	45% x NWP[5,7]

Notes

[1]Basel I regulatory ratios and regulatory requirements.
[2]NBC has obtained dispensation from the Bank of Tanzania for the breach of the minimum regulatory requirements. Appropriate management actions are underway of this regard.
[3]Financial Services Board.
[4]Capital adequacy requirement (CAR): Actuarial calculation of value at risk on insurance liabilities. 2,0 times (2011: 2,0 times) being the required capital level determined by Absa Life Limited.
[5]NWP: Net Written Premiums.
[6]45% (2011: 45%) of NWP, being the required capital level determined by Absa Insurance Company Limited.
[7]Quota share reinsurance is used to maintain capital adequacy levels at a level sufficient in excess of the regulatory minimum.

Regulatory capital

Risk-weighted assets (RWAs)

RWAs are determined by applying the following methods per risk type in accordance with the Basel II.5, revisions which became effective 1 January 2012:

- AIRB approach for credit risk;
- AMA for operational risk[2];
- in respect of traded market risk, IMA for general position risk, and Standardised Approach (SA) for issuer specific risk;
- Internal Ratings Based (IRB) market-based simple risk-weighted method for equity investment risk in the banking book; and
- standardised approach for credit risk in all African entities.

RWAs and minimum required capital – Group	30 June				31 December	
	2012		2011		2011	
	RWAs Rm	Minimum required capital[1] Rm	RWAs Rm	Minimum required capital[1] Rm	RWAs Rm	Minimum required capital[1] Rm
Basel II measurement approach						
Credit risk	311 737	29 615	298 851	28 391	317 920	30 202
Portfolios subject to the AIRB approach	300 209	28 520	143 220	13 606	145 870	13 858
Portfolios subject to the FIRB approach	—	—	143 651	13 647	159 740	15 175
Portfolios subject to the standardised approach	10 212	970	9 409	894	10 595	1 006
Securitisation[3]	1 316	125	2 571	244	1 715	163
Equity investment risk						
Market-based approach (simple risk-weighted approach)	23 864	2 267	24 136	2 293	22 168	2 106
Market risk	13 354	1 269	9 852	936	8 357	794
Standardised approach	3 257	310	3 058	291	3 828	364
Internal models approach (IMA)	10 097	959	6 794	645	4 529	430
Operational risk						
Advanced measurement approach (AMA)[2]	60 786	5 775	59 037	5 609	59 460	5 649
Non-customer assets	16 711	1 587	16 521	1 569	16 584	1 575
	426 452	40 513	408 397	38 798	424 489	40 326
Pillar 1 requirement (8%)		34 116		32 672		33 959
Pillar 2a requirement (1,5%)		6 397		6 126		6 367

Notes

[1]The required capital is the regulatory minimum (9,5%) excluding the bank specific (Pillar 2b) add on.

[2]AMA for operational risk, except for an immaterial portion of the Group that uses the Basic Indicator Approach, or Standardised Approach.

[3]The separate disclosure of credit risk RWA pertaining to securitisation resulted in a reclassification of comparative information.

Capital management

Regulatory capital *(continued)*

Risk-weighted assets (RWAs) *(continued)*

RWAs and minimum required capital – Bank	30 June 2012 RWAs Rm	30 June 2012 Minimum required capital[1] Rm	30 June 2011 RWAs Rm	30 June 2011 Minimum required capital[1] Rm	31 December 2011 RWAs Rm	31 December 2011 Minimum required capital[1] Rm
Basel II measurement approach						
Credit risk	**283 620**	**26 944**	275 603	26 182	289 949	27 545
Portfolios subject to the AIRB approach	**282 304**	**26 819**	133 186	12 652	135 071	12 832
Portfolios subject to the FIRB approach	**—**	**—**	139 846	13 286	153 163	14 550
Securitisation[3]	**1 316**	**125**	2 571	244	1 715	163
Equity investment risk						
Market-based approach (simple risk-weighted approach)	**25 669**	**2 439**	26 824	2 548	24 555	2 333
Market risk	**13 329**	**1 266**	9 852	936	8 357	794
Standardised Approach	**3 232**	**307**	3 058	291	3 828	364
IMA	**10 097**	**959**	6 794	645	4 529	430
Operational risk						
AMA[2]	**52 867**	**5 022**	50 654	4 812	51 067	4 851
Non-customer assets	**11 005**	**1 045**	10 852	1 031	11 005	1 046
	386 490	**36 716**	373 785	35 509	384 933	36 569
Pillar 1 requirement (8%)		**30 919**		29 903		30 795
Pillar 2a requirement (1,5%)		**5 797**		5 606		5 774

Notes

[1]The required capital is the regulatory minimum (9,5%) excluding the bank specific (Pillar 2b) add on.

[2]AMA for operational risk, except for an immaterial portion of the Group that uses the Basic Indicator Approach, or Standardised Approach.

[3]The separate disclosure of credit risk RWA pertaining to securitisation resulted in a reclassification of comparative information.

Capital supply

The Group increased its total qualifying capital supply for the six months ended 30 June 2012 by R1,5 billion (30 June 2011: R2,8 billion; 31 December 2011: R5,4 billion).

	Six months ended 30 June		Year ended 31 December	Six months ended 30 June		Year ended 31 December
	Group			Bank		
Movements in qualifying capital	**2012 Rm**	2011 Rm	2011 Rm	**2012 Rm**	2011 Rm	2011 Rm
Balance at the beginning of the year (excluding unappropriated profits)	**62 489**	62 770	62 770	**56 409**	56 890	56 890
Share capital, premium and reserves	**3 860**	(23)	37	**3 932**	(133)	(175)
Non-controlling interest – ordinary shares	**(62)**	86	238	**—**	—	—
Tier 2 subordinated debt issued	**—**	—	—	**—**	—	—
Tier 2 subordinated debt matured	**—**	—	—	**—**	—	—
General allowance for credit impairments: standardised approach	**9**	1	3	**—**	—	—
Regulatory deductions	**235**	(26)	(559)	**300**	47	(306)
Balance at the end of the period/year (excluding unappropriated profits)	**66 531**	62 808	62 489	**60 641**	56 804	56 409
Add: unappropriated profits	**5 730**	5 361	8 291	**3 435**	3 150	6 040
Qualifying capital including unappropriated profits	**72 261**	68 169	70 780	**64 076**	59 954	62 449

Capital management

Capital supply *(continued)*

Breakdown of qualifying capital – Group	30 June 2012 Qualifying capital Rm	30 June 2012 %[1]	30 June 2011 Qualifying capital Rm	30 June 2011 %[1]	31 December 2011 Qualifying capital Rm	31 December 2011 %[1]
Core Tier 1	50 619	11,9	46 816	11,5	46 685	11,0
Ordinary share capital	1 434	0,3	1 434	0,4	1 434	0,3
Ordinary share premium	4 572	1,1	4 562	1,1	4 676	1,1
Reserves[2]	46 279	10,9	42 368	10,4	42 314	10,0
Non-controlling interest – ordinary shares	1 391	0,3	1 301	0,3	1 453	0,3
Deductions	(3 057)	(0,7)	(2 849)	(0,7)	(3 192)	(0,7)
Goodwill	(553)	(0,1)	(572)	(0,1)	(568)	(0,1)
50% of financial and insurance entities not consolidated	(154)	(0,0)	(62)	(0,0)	(122)	(0,0)
50% of amount by which expected loss exceeds eligible provisions	(1 220)	(0,3)	(1 222)	(0,3)	(1 352)	(0,3)
Other deductions	(1 130)	(0,3)	(993)	(0,3)	(1 150)	(0,3)
Non-core Tier 1						
Preference share capital and premium	4 644	1,1	4 644	1,1	4 644	1,1
Tier 1 capital (primary capital)	55 263	13,0	51 460	12,6	51 329	12,1
Tier 2 capital (secondary capital)	11 268	2,6	11 348	2,8	11 160	2,6
Subordinated redeemable debt	12 611	2,9	12 611	3,1	12 611	2,9
General allowance for credit impairment, after deferred tax – SA	31	0,0	21	0,0	23	0,0
Deductions	(1 374)	(0,3)	(1 284)	(0,3)	(1 474)	(0,3)
50% of financial and insurance entities not consolidated	(154)	(0,0)	(62)	(0,0)	(122)	(0,0)
50% of amount by which expected loss exceeds eligible provisions	(1 220)	(0,3)	(1 222)	(0,3)	(1 352)	(0,3)
Total qualifying capital (excluding unappropriated profits)	66 531	15,6	62 808	15,4	62 489	14,7
Qualifying capital (including unappropriated profits)						
Tier 1 capital	60 993	14,3	56 821	13,9	59 620	14,1
Core Tier 1 (excluding unappropriated profits)	50 619	11,9	46 816	11,5	46 685	11,0
Unappropriated profits	5 730	1,3	5 361	1,3	8 291	2,0
Non-core Tier 1	4 644	1,1	4 644	1,1	4 644	1,1
Tier 2 capital	11 268	2,6	11 348	2,8	11 160	2,6
Total qualifying capital (including unappropriated profits)	72 261	16,9	68 169	16,7	70 780	16,7

Notes
[1]Percentage of capital to RWA.
[2]Reserves exclude unappropriated profits.

Capital supply *(continued)*

Breakdown of qualifying capital – Bank	30 June 2012 Qualifying capital Rm	30 June 2012 Qualifying capital %[1]	30 June 2011 Qualifying capital Rm	30 June 2011 Qualifying capital %[1]	31 December 2011 Qualifying capital Rm	31 December 2011 Qualifying capital %[1]
Core Tier 1	44 734	11,6	40 905	11,0	40 655	10,6
Ordinary share capital	303	0,1	303	0,1	303	0,1
Ordinary share premium	11 465	3,0	11 465	3,1	11 465	3,0
Reserves[2]	34 891	9,0	31 001	8,3	30 959	8,0
Deductions	(1 925)	(0,5)	(1 864)	(0,5)	(2 072)	(0,5)
50% of amount by which expected loss exceeds eligible provisions	(1 348)	(0,4)	(1 356)	(0,4)	(1 501)	(0,4)
Other deductions	(577)	(0,1)	(508)	(0,1)	(571)	(0,1)
Non-core Tier 1						
Preference share capital and premium	4 644	1,2	4 644	1,2	4 644	1,2
Tier 1 capital (primary capital)	49 378	12,8	45 549	12,2	45 299	11,8
Tier 2 capital (secondary capital)	11 263	2,9	11 255	3,0	11 110	2,9
Subordinated redeemable debt	12 611	3,3	12 611	3,4	12 611	3,3
Deductions						
50% of amount by which expected loss exceeds eligible provisions	(1 348)	(0,4)	(1 356)	(0,4)	(1 501)	(0,4)
Total qualifying capital (excluding unappropriated profits)	60 641	15,7	56 804	15,2	56 409	14,7
Qualifying capital (including unappropriated profits)						
Tier 1 capital	52 813	13,7	48 699	13,0	51 339	13,3
Core Tier 1 (excluding unappropriated profits)	44 734	11,6	40 905	11,0	40 655	10,6
Unappropriated profits	3 435	0,9	3 150	0,8	6 040	1,5
Non-core Tier 1	4 644	1,2	4 644	1,2	4 644	1,2
Tier 2 capital	11 263	2,9	11 255	3,0	11 110	2,9
Total qualifying capital (including unappropriated profits)	64 076	16,6	59 954	16,0	62 449	16,2

Notes
[1]Percentage of capital to RWA.
[2]Reserves exclude unappropriated profits.

Capital management

Capital transferability

The Group is the primary provider of equity capital to its subsidiaries and capital is held centrally in accordance with the board-approved annual Group capital plan.

The Group policy stipulates that capital held in Group entities in excess of board approved target levels/ranges should be repatriated to the Group in the form of dividends and/or capital repatriation, subject to local regulatory requirements, exchange controls and strategic management decisions. Apart from the aforesaid, the Group is not aware of any material impediments to the prompt transfer of capital resources or repayment of intragroup liabilities when due.

Economic capital requirements

The Group assesses EC requirements by measuring its risk profile using both internally and externally developed models. The Group assigns EC primarily within six risk categories: retail and wholesale credit risk (including residual value risk), traded and non-traded market risk, operational risk, fixed assets risk and equity investment risk in the banking book.

The Group regularly enhances its EC methodologies and benchmarks outputs to external reference points. Industry benchmarks and best practice are considered and used in its evaluation and enhancement of existing economic capital methodologies.

The EC methodology incorporates the key credit risk parameters based on average credit conditions (through-the-cycle (TTC) effect), rather than those prevailing at the balance sheet date (point-in-line (PIT) effect). This seeks to reduce cyclicality from the economic capital calculation. It also reflects the time horizon, correlation of risks and risk concentrations.

The EC framework covers not only Basel II Pillar 1 risks but also additional economic risks not covered at all, or inadequately covered in Pillar 1 such as interest rate risk in the banking book. Furthermore, another risk included as an add-on to EC is concentration risk within the credit portfolio.

The total average EC required by the Group, determined by the risk assessment models and considering the Group's estimated portfolio effects is compared with the available financial resources (EC supply) the evaluate EC utilisation.

Economic capital resources

The resources available to meet EC requirements are calculated as the average available shareholders' equity after adjustment including preference shares, but excluding other non-controlling interests. The Group's EC calculations form the basis of the Group's submission for the Basel II ICAAP.

Funds available for EC are impacted by a number of factors that have arisen from the application of IFRS.

EC supply includes:

- ordinary shareholders' equity;
- retained earnings, whether appropriated or not; and
- non-redeemable, non-cumulative preference shares.

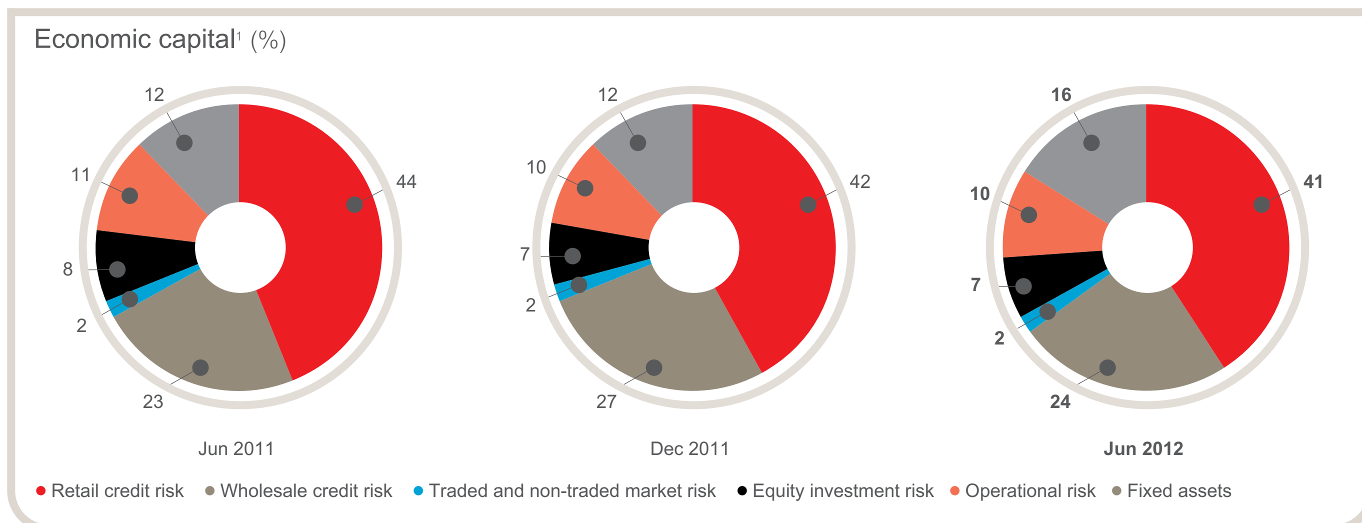
The following equity reserves are excluded from EC resources:

- cash flow hedging reserve: to the extent that the Group undertakes the hedging of future cash flows, shareholders' equity will include gains and losses that will be offset against the gain or loss on the hedged item when it is recognised in the statement of comprehensive income at the conclusion of the hedged transaction. Given the future offset of such gains and losses, they are excluded from shareholders' equity when calculating EC;
- available-for-sale reserve: unrealised gains and losses on such securities are included in shareholders' equity until disposal or impairment. Such gains and losses are excluded from shareholders' equity for the purposes of calculating EC;
- retirement benefit assets and liabilities: the Group has recorded a surplus with a consequent increase in shareholders' equity. This represents a non-cash increase in shareholders' equity. For the purposes of calculating EC, pension surplus is excluded from shareholders' equity;
- non-controlling interest;
- other perpetual debt, preference shares and subordinated debt; and
- tertiary capital.

The following are deducted from EC supply:

- goodwill; and
- intangible assets.

Economic capital resources *(continued)*



Capital Risk

Translation foreign exchange risk

Translational foreign exchange risk arises from capital resources (including investments in subsidiaries and branches, intangible assets, non-controlling interests, deductions from capital and debt capital instruments) and RWAs being denominated in foreign currencies. Changes in foreign exchange rates result in changes in the South African rand (ZAR) equivalent value of foreign currency denominated capital resources and RWAs.

The Group's investments in foreign currency subsidiaries and branches create capital resources denominated in foreign currencies. Changes in the ZAR value of the investments resulting from foreign currency movements are captured in the currency translation reserve, which are currently excluded from qualifying capital resources under SARB rules.

Note

[1]Excludes insurance due to difference in confidence level in terms of insurance regulation

Capital Risk *(continued)*

Translation foreign exchange risk *(continued)*

To minimise volatility of capital ratios caused by foreign exchange rate movements, the Group aims to maintain an appropriate foreign currency capital structure by maintaining the ratio of foreign currency Core Tier 1, Tier 1 and total capital resources to foreign currency RWAs in line with the Group's capital risks. This is primarily achieved by subsidiaries issuing capital or holding retained earnings in local currencies or through the Group issuing debt capital in foreign currency.

Translational foreign currency risk can be mitigated through derivatives or borrowings in the same currency as the functional currency involved, designated as net investment hedges, or through economic hedges. Translational hedging considerations include exchange control regulations, the strategic nature of the investment, materiality of the risk, prevailing foreign exchange rates, market liquidity, cost of hedging and the impact on capital ratios. Based on these considerations, no foreign currency net investment hedges were in place for the six month ended 30 June 2012.

Translational foreign exchange risk is monitored regularly to consider the need for mitigating actions towards minimising material fluctuations. A sensitivity analysis is provided in the Market Risk section of this document.

Credit ratings

	June 2012	July 2012	
	Moody's[1]	Fitch ratings[2]	
	Absa Bank	Absa Bank	Absa Group
National			
Short-term	Prime-1.za	F1+ (zaf)	F1+ (zaf)
Long-term	Aa2.za	AA+ (zaf)	AA+ (zaf)
Outlook	—	Stable	Stable
Local currency			
Short-term	Prime-2	—	—
Long-term	A3	A–	A–
Outlook	Stable	Stable	Stable
Foreign currency			
Short-term	Prime-2	F2	F2
Long-term	A3	A–	A–
Outlook	Negative	Stable	Stable
Bank's financial strength	C-	C	C
Baseline Credit Assessment[3]	Baa1	—	—
Viability Rating[4]	—	bbb+	bbb+
Outlook	Stable	Stable	Stable
Support	—	1	1

Notes

[1]With regards to Absa Bank's EMTN programme, the provisional foreign-currency senior unsecured debt rating has been downgraded to (P)A3 from (P)A2. Any issued foreign-currency senior unsecured debt has been downgraded to A3 from A2. The provisional foreign-currency subordinated and junior subordinated debt ratings under its EMTN programme have also been downgraded to (P)Baa2 and (P)Baa3, from (P)Baa1 and (P)Baa2 respectively. All ratings have a stable outlook.

[2]Senior unsecured debt: Long-term foreign currency, rating confirmed at 'F2'. Senior unsecured notes National long-term rating affirmed at 'AA' + (Zaf).

[3]The baseline credit assessment reflects what the local currency deposit rating of the bank with the given Bank Financial Strength Rating would be without any assumed external support from a government or third party.

[4]Fitch introduced a Viability rating on financial institutions around the globe, with effect from July 2011, which represents Fitch's primary assessment of the intrinsic (standalone) creditworthiness of these institutions.

Operational Risk

Contents

115 – 120 Operational risk

115 Overview
117 Operational risk

Approach to operational risk.

Overview

Key points to note

- Advanced measurement approach (AMA) approval by SARB maintained, subject to RC floors.
- Operational risk losses still within year-end budget; a year-on-year increase in value of losses experienced.
- Continued improvements in control environment strongly evidenced by reduction in volume of loss events for 2012.
- Risk and control assessments and key risk indicators do not indicate any adverse risk beyond operational risk appetite.

Key performance indicators

Movement from prior period	30 June		31 December
	2012	2011	2011
Total number of events	↓	↓	↓
Total loss value	↑	↓	↓

Introduction

Operational risk is the risk of direct or indirect losses resulting from inadequate or failed internal processes or systems, human error or external events. Operational risk exists in the natural course of business activity.

The Group recognises the significance of operational risk and is committed to enhancing the measurement and management thereof. Within the Group's operational risk framework, qualitative and quantitative methodologies and tools are applied Group-wide to identify and assess operational risks and to provide management with information for determining appropriate mitigating measures.

Strategy

The Group's operational risk management objectives are to:

- further embed an operational risk-aware culture throughout the Group by setting the tone from the top;
- hold a risk-sensitive RC for operational risk under the AMA;
- enhance controls using automated solutions as far as possible, specifically relating to fraud and e-fraud;
- meet regulatory requirements through the implementation of best practices in managing and measuring risk;
- set and monitor appropriate operational risk appetite and tolerance levels; and
- further improve and embed post-event follow-up and recovery actions, including full control reviews related to unexpected losses.

June 2012 in review

The Group's operational risk profile is considered acceptable, with management actions in place to mitigate risk that might negatively impact the profile. Risk and Control's Assessments (RCAs) and Key Indicators (KIs) do not indicate any adverse risk beyond appetite.

While there has been a year-on-year increase in the value operational risk losses, there has been a decrease in the volume of losses, indicating a continued focus on reducing losses.

Control improvements across the Group continue to show benefits. This can be evidenced by the reduction in the volume of events from previous reporting period. Significant investment has been made over the past two years in improving controls that will further mitigate fraud losses. The Group also focussed on improving process efficiencies, resulting in a more streamlined environment where risks are more effectively managed.

While aggressive growth plans will lead to proportional increases in expected losses, improvements and focus on the control environment, as well as efficiencies are expected to offset this, resulting in slower growth in fraud and other losses.

Overview

Looking ahead

Today's economic and regulatory environments demand that we remain agile in both our meeting of new and changed requirements and in our innovation of products and service offerings. A key focus area will be to ensure that operational risks related to the implementation of new projects and programmes are effectively mitigated.

Fraud remains a major driver of our operational risk losses. We will continue embedding fraud prevention and detection processes and controls through the roll out of our technology road map for fraud. This is expected to limit increases in losses. Fraud will remain a key operational risk within the Group, as is the case throughout the industry.

Technology risk management capabilities will be further enhanced. Increased automating of manual processes will result in fewer handovers and less opportunity for human error. Advancing our leverage of technology will also serve to enrich customer experience by reducing paper work and improving efficiencies.

In the light of regulatory changes and increasing focus on consumer protection, trends relating to consumerism – not currently a source of losses – will be monitored to identify any emerging risks.

Approach to operational risk

Operational risk is a principal risk (managed through an associated Operational Risk Framework (ORF), which is underpinned by a taxonomy of Key Risks. These Key Risks constitute the risk environment for Operational Risk and are all owned by relevant senior management with the appropriate expertise. For example, the People Key Risk is owned by the Group HR Executive, while the Technology Key Risk is owned by the Chief Information Officer. The ORF comprises a number of elements which allow the Group to manage and measure its operational risk profile and to calculate the amount of operational risk capital the Group needs to hold to absorb potential losses. The minimum, mandatory requirements for each of these elements are set out in the Group Operational risk policies. These policies are implemented across the Group: vertically, through the organisational structure with all business required to implement and operate the ORF that meets, as a minimum, the requirements detailed in these operational risk policies; and horizontally, with the Group Key Risk Owners required to monitor information relevant to their key risk from each ORF element.

The management of operational risk has two key objectives:

- To minimise the impact of losses suffered in the normal course of business (expected losses) and to avoid or reduce the likelihood of suffering a large extreme (or unexpected) loss; and
- To improve the effective management of the Group and strengthen its brand and external reputation.

Absa is committed to the management and measurement of operational risk and was granted approval to operate an AMA for operational risk under Basel II, which commenced in January 2008. The majority of the Group calculates regulatory capital using AMA, however, in specific areas we apply the Basic Indicator Approach. In certain joint ventures and associates, the Group may not be able to apply the AMA.

Operational risk is one of four Principal Risks in the Principal Risks Framework and comprises a number of specific key risks defined as follows:

- External supplier risk – Inadequate selection and ongoing management of external suppliers.
- Financial reporting risk – Reporting miss-statement or omission within external financial or regulatory reporting.
- Fraud risk – Dishonest behaviour with the intent to make a gain or cause a loss to others.
- Information risk – Inadequate protection of Absa information in accordance with its value and sensitivity.
- Legal risk – Failure to identify and manage legal risks.
- Product risk – Inadequate design, assessment and testing of products/ services.
- Payment process risk – Failure in operation of payments processes.

Approach to operational risk *(continued)*

- People risk – Insufficient people /capabilities and/or inappropriate behaviours and/or unsafe working environments.
- Premises and security risk – Unavailability of premises to meet business requirements or inadequate protection of physical assets, employees and customers against criminal, terrorist and adverse political activities.
- Regulatory risk – Failure or inability to comply fully with the laws, regulations or codes applicable specifically to the financial services industry.
- Taxation risk – Failure to comply with tax laws and practice which could lead to financial penalties, additional tax charges or reputational damage.
- Technology risk – Failure to develop and deploy secure, stable and reliable technology solutions.
- Transaction operations risk – Failure in the management of critical transaction processes.

These risks can result in financial and/or non-financial impacts including legal/regulatory breaches or reputational damage.

The Group operates within a robust system of internal control that enables business to be transacted and risk taken without exposure to unacceptable potential losses or reputational damage.

The prime responsibility for the management of operational risk rests with the business and functional units where the risk arises. Operational risk managers are widely distributed throughout the Group and support these areas, assisting line managers in understanding and managing their risks. The Head of Operational Risk for each of the product lines are responsible for ensuring the implementation of and compliance with Group Operational Risk policies.

The Group Operational Risk function is responsible for establishing, owning and maintaining an appropriate Group-wide ORF and for overseeing the portfolio of operational risk across the Group. The ORC is the senior executive body responsible for the oversight and challenge of operational risk in the Group. The ORC presents relevant risk profile information to the GRCMC.

In addition, business unit CRCs monitor control effectiveness. The Group CRC receives reports from these committees and considers Group-significant control issues and their remediation. The Group CRC presents relevant information to the GACC.

Business units are required to report their operational risks on both a regular and an event-driven basis. The reports include a profile of the material risks to their business objectives and the effectiveness of key controls, control issues of Group-level significance, operational risk events and a review of capital. Specific reports are prepared on a regular basis for the ORC, Group CRC, GRCMC and GACC.

Operational risk is recorded and reported according to the ORF. The Group applies the AMA to calculate the economic and regulatory capital requirements for operational risk and is subject to the relevant RC floors, communicated by the SARB from time to time. However, certain areas are not included in the AMA approach, namely:

- joint ventures and non-controlling interests where the Group is unable to dictate the ORF or capital methodology;
- any cross-border legal entities where local regulatory policy/requirements either do not permit the use of or do not support the practical implementation of the AMA framework; and
- certain subsidiaries where partial AMA is applied.

The objective of the operational risk management methodology is to ensure the Group manages operational risks in an optimal and consistent manner, making certain these risks are measured accurately and the Group is adequately capitalised. A further aim is to increase the efficiency and effectiveness of the Group's resources, and to make use of growth opportunities while minimising operational risks.

Operational risk

Approach to operational risk *(continued)*

The Group ORF has been designed to meet external and internal governance requirements including Basel and the Banks' Act. The ORF includes the following elements:

Risk and Control Assessments (RCAs)

The Group identifies and assesses all material risks within the business and evaluates the key controls in place to mitigate those risks. Managers in the business use self-assessment techniques to identify risks, evaluate the effectiveness of key controls in place and assess whether the risks are effectively managed within business risk appetite. The businesses are then able to make decisions on what, if any, action is required to reduce the level of risk to the Group. These risk assessments are monitored on a regular basis to ensure that each business continually understands the risks it faces.

Internal Risk Events (IREs)

An operational risk event is any circumstance where, through the lack or failure of a control, the Group has actually, or could have, made a loss. The definition includes situations in which the Group could have made a loss, but in fact made a gain, as well as incidents resulting in reputational damage or regulatory impact only. Thresholds are used across the Group for reporting risk events and as part of our analysis we seek to identify where improvements are needed to processes or controls, to reduce the recurrence and/or magnitude of risk events. The Group also uses a database of external risk events which are publicly available and via Barclays is a member of the operational risk data exchange (ORX), a not-for-profit association of international banks formed to share anonymous loss data information. The Group uses this external loss information to support and inform risk identification, assessment and measurement.

Key Indicators (KIs)

KIs are metrics which allow the Group to monitor its operational risk profile. KIs include measurable thresholds that reflect the risk appetite of the business. KIs are monitored to alert management when risk levels exceed acceptable ranges or risk appetite levels and drive timely decision making and actions.

Key Risk Scenarios (KRSs)

By combining data from RCAs, KIs, IREs, External Risk Events, audit findings, expert management judgement and other internal data sources, the Group is able to generate Key Risk Scenarios (KRSs). These scenarios identify the most significant operational risks across the Group. The KRSs are validated at a business level as well as at a Group level.

Basel II measurement elected

Operational risk is recorded and reported according to the ORF. The Group applies the AMA to calculate the economic and regulatory capital requirements for operational risk and is subject to the relevant RC floors, communicated by the SARB from time to time. However, certain areas are not included in the AMA approach, namely:

- joint ventures and non-controlling interests where the Group is unable to dictate the implementation of the ORF or capital methodology;
- any cross-border legal entities where local regulatory policy/requirements either do not permit the use of or do not support the practical implementation of the AMA framework; and
- certain subsidiaries where partial AMA is applied.

Capital modelling

The model used to determine the Group's operational risk capital is periodically reviewed and approved for continued use. The need for any changes or updates to the model is considered on an ongoing basis to ensure that it is in line with best practice as well as narrowing industry practices and regulatory feedback. Any such changes deemed necessary follow a robust internal process of development and approval prior to being submitted for regulatory approval where relevant.

The AMA approach follows a key risk scenario-based process. Key Risk Scenarios (KRSs) use internal and external data to determine exposures for the Group. KRSs exist for all of the Key Risks as detailed in the Principal Risk Framework under Operational Risk. Currently, the most significant KRSs relate to the Fraud, Transaction Operations and Regulatory Key Risks. These key risks will thus also account for the most amount of capital.

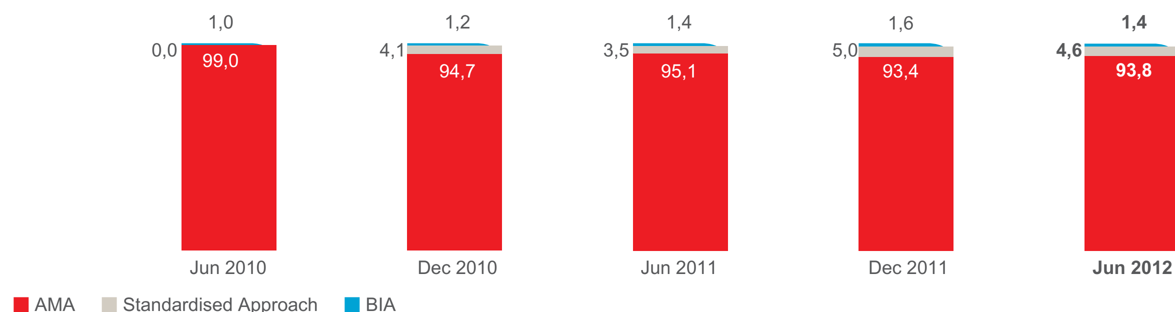
KRSs are the main input to the model and assess the Group's material operational risks on an expected and unexpected basis. The KRSs provide a forward-looking view of operational risk and the Group believes this is currently the most effective way to measure unexpected losses. KRSs are also used as a tool in managing operational risk.

For each KRS, a frequency and severity distribution is constructed and aggregated to derive the Group loss distribution. The modelled regulatory capital is measured at a 99,9% confidence level. Once the overall regulatory capital for the Group has been established it is allocated to product lines based on a methodology that includes a risk-sensitive component.

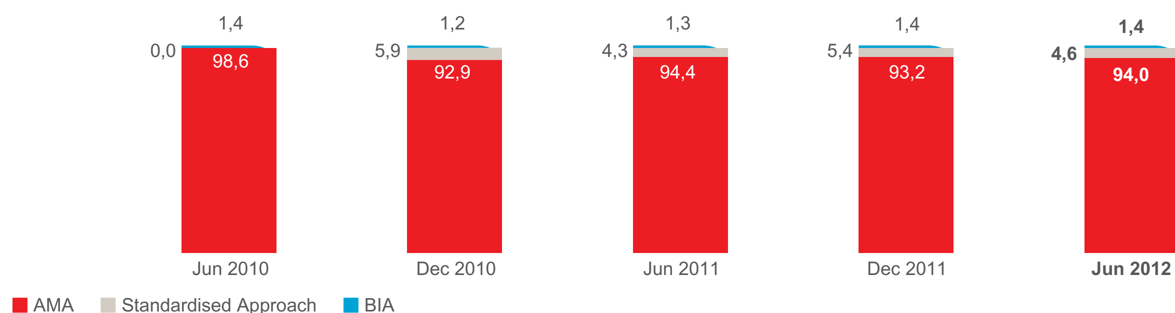
Coverage of the AMA approach

The AMA approach is applied across the Group. Each component of the framework provides effective risk management and indirectly also determines the capital that should be held. The resultant capital split is indicated below.

Economic capital (%) by approach for operational risk



Required capital (%) by approach for operational risk



Insurance in mitigation of operational risk

Insurance is used as a mechanism to mitigate operational risk. The Group's Short-Term Insurance Committee (STIC) led by the CRO is responsible for designing and for managing the principal insurance programmes that mitigate key aspects of the Group's operational risk. The STIC ensures that these policies are current and remain applicable to the Group's operating environment. The STIC also oversees specific insurance cover purchased at Group or segment level to discharge statutory and regulatory duties, or to meet counterparty commitments and stakeholder expectations.

The primary insurance policies that cover the Group are:

- comprehensive crime and electronic crime/professional liability;
- directors' and officers' liability;
- professional indemnity; and
- various asset and motor policies.

Glossary

Contents

123 –134 Appendix

123 Glossary
131 List of abbreviations

Appendix

Glossary

Advanced approaches

Methods available to banks to calculate their regulatory capital requirements based on own risk estimates. These include the Foundation and Advanced Internal Ratings-based (AIRB) approach for credit risk, the Advance Measurement Approach (AMA) for operational risk, and the Internal Models Approach (IMA) for market risk.

ALCO

The Asset and Liability Committee oversees the management and governance of the Group balance sheet that drives sustainable shareholder value over the longer term, including overall risk vs. return, capital, liquidity and funding allocation.

ALM

Asset liability management is the ongoing process of formulating, implementing, monitoring and revising strategies related to banking book assets and liabilities in an attempt to:

- maximise the interest margin; and
- manage the risk to earnings and capital arising from changes in financial market rates and the group's mix of assets and liabilities.

ALM encompasses the management of liquidity risk, interest rate risk and exchange rate risk in the banking book through the use of both on and off-balance-sheet instruments and strategies.

Back-testing

A statistical technique used to monitor and assess the accuracy of a model, and how that model would have performed had it been applied in the past.

Banking book

Group assets, liabilities and off-balance-sheet items that are not in the trading book.

Basel Committee

Basel Committee on Banking Supervision.

Basel (II, II.5 and III)

The Basel Capital Accord of the Bank for International Settlements is an improved capital adequacy framework aimed at closely aligning banks' capital requirements with improved modern risk management practices and sophisticated risk assessment capabilities. It further ensures the risk sensitivity of the minimum capital requirements by including supervisory reviews and market discipline through enhanced disclosure. In South Africa Basel II became effective from 1 January 2008, Basel II.5 became effective from 1 January 2012 and Basel III will become effective from 1 January 2013.

Bank

Absa Bank Limited, together with its subsidiary undertakings, special purpose entities, joint ventures and offshore holdings. Referred to as 'the Bank' in the ICAAP.

Banks Act

This means the Banks Act, No 94 of 1990 and its regulations.

Barclays

Barclays Group PLC registered in England under registration number 1026167, and the majority shareholder of Absa Group Limited.

Capital: Primary (Tier 1) capital

A component of regulatory capital, comprising Core Tier 1 capital and other Tier 1 capital. Other Tier 1 capital includes qualifying hybrid capital instruments such as non-cumulative perpetual preference shares and innovative Tier 1 securities.

Glossary

Capital: Secondary (Tier 2) capital

A component of regulatory capital, comprising qualifying subordinated loan capital, related minority interests, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available-for-sale. Tier 2 capital also includes reserves arising from the revaluation of properties.

Capital: Tertiary (Tier 3) capital

A component of regulatory capital, comprising qualifying subordinated loan capital, related minority interests, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available-for-sale. Tier 2 capital also includes reserves arising from the revaluation of properties.

Capital adequacy ratio (CAR)

The capital adequacy of South African banks is measured in terms of SARB requirements. The ratio is calculated by dividing the primary (Tier 1), secondary (Tier 2) and tertiary (Tier 3) capital by the risk-weighted assets. The minimum South African total capital adequacy ratio for banks is 9,75% of risk-weighted assets. Non-South African banks within the Group have similar capital adequacy methodology requirements.

Capital management

Capital management manages capital risk. It also:

- ensures the efficient planning to ensure that the Group's capital is in line with the requirements of the regulators, internal assessment of the level of risk being taken by the Group, the expectations of the rating agencies and debt holders as well as the returns expected by shareholders; and
- takes advantage of the range of capital instruments and activities to optimise the financial efficiency of the capital base.

Capital risk

The risk that the Group's total capital base is not properly managed in a prudent manner. Capital risk arises when the Absa Group does not have adequate levels of capital resources to support its risk appetite, current and planned business activities and regulatory requirements.

Commercial paper

An unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. The debt is usually issued at a discount, reflecting prevailing market interest rates.

Commercial real estate

Any real estate investment, comprising buildings or land, intended to generate a profit, either from capital gain or rental income.

Core tier 1 capital

The highest quality form of regulatory capital that comprises total shareholders' equity and related minority interests, less goodwill and intangible assets, and certain other regulatory adjustments.

Concentration risk

A concentration of credit risk exists when a number of counterparties are located in a geographical region, and/or are engaged in similar activities and/or have similar economic characteristics such that their ability to meet contractual obligations is similarly affected by changes in economic or other conditions.

Country transfer risk

Country transfer risk arises when an actual or potential financial obligation is incurred by a counterparty in one country, and owed to the bank in another country. As well as incurring credit risk, such liabilities will also be subject to political and economic conditions in the obligor's country, which may prevent the obligor (or collateral provider) from discharging its external obligations. Country transfer risk is included in EC because of the ratings cap, but is not included in RC.

Glossary

Credit default swap

A derivative contract whereby a buyer pays a fee to a seller in return for receiving a payment in the event of a defined credit event (e.g. bankruptcy, payment default on a reference asset or assets, or downgrades by rating agency) on an underlying obligation (which may or may not be held by the buyer).

Credit enhancements

Facilities used to enhance the creditworthiness of financial obligations and cover losses due to asset default.

Credit rating

A credit rating is an assessment as to the borrower's ability to meet future payment obligations, i.e. it is the probability of default of the borrower.

Credit risk

Credit risk arises mainly from lending and related banking activities, including underwriting, dealing in traded products such as derivative contracts, and securities borrowing and lending products. It may also arise when fair values of the Group's exposure to financial instruments decline.

Retail credit risk – Retail credit risk is the risk of loss to the Group arising from the failure of retail customers or counterparties to fulfil its payment obligations.

Wholesale credit risk – Wholesale credit risk is the risk of loss to the Group arising from the failure of wholesale customers or counterparties to fulfil its payment obligations.

Credit risk adjustment

An adjustment to the valuation of the OTC derivatives contracts to reflect the creditworthiness of OTC derivative counterparties.

Credit risk mitigation

A technique to reduce the credit risk associated with an exposure by application of credit risk mitigants such as collateral, guarantees and credit protection.

Dividend cover

Headline earnings per share, divided by dividends per share.

Economic capital

An internally calculated capital requirement deemed necessary by Absa to support the risks to which it is exposed, at a confidence level consistent with a target credit rating of AA.

Economic profit

The difference between the return on financial capital invested by shareholders (return on invested capital) and the cost of that capital.

Equity risk in the banking book (ERBB)

The risk of decline in the net realisable value of equity exposures in the banking book.

These include:

- investment in securities (listed and unlisted equity holdings, whether direct or indirect, and includes private equity); and
- investment in associate companies and joint ventures.

Glossary

Expected loss (‘EL’) (regulatory)

A regulatory calculation of the amount expected to be lost on an exposure using a 12-month time horizon and downturn loss estimates. EL is calculated by multiplying the Probability of Default (a percentage) by the Exposure at Default (an amount) and Loss Given Default (a percentage).

Exposure

A claim, contingent claim or position which carries a risk of financial loss.

Exposure at default (‘EAD’)

The amount expected to be outstanding after any credit risk mitigation, if and when a counterparty defaults. EAD reflects drawn balances as well as allowance for undrawn amounts of commitments and contingent exposures.

Exposure value

Exposure at default (‘EAD’).

Fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

Foreign exchange risk in the banking book

The risk that known or ascertainable currency cashflow commitments and receivables are uncovered and as a result have an adverse impact on the financial results and/or financial position of the group due to movements in exchange rates.

Group

Absa Group Limited, together with its subsidiary undertakings, special purpose entities, joint ventures and offshore holdings. It is also referred to as ‘the Group’ in the ICAAP.

Haircut

With respect to credit risk mitigation, an adjustment to collateral value to reflect any currency or maturity mismatches between the credit risk mitigant and the underlying exposure to which it is being applied. Also a valuation adjustment to reflect any fall in value between the date the collateral was called and the date of liquidation or enforcement.

Impaired loans

Loans where the Group does not expect to collect all the contractual cash flows or expects to collect them later than they are contractually due.

Insurance risk

A risk, other than financial risk, transferred from the holder of a contract to the insurance provider. The principal insurance risk is that, over time, the combined cost of claims, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income.

Internal Assessment Approach (‘IAA’)

One of three calculation methods defined under the IRB approach to securitisations. The IAA is limited to exposures arising from asset backed commercial paper programmes, mainly related to liquidity facilities and credit enhancement. The approach consists of mapping an internal rating methodology for credit exposures to those of an external credit assessment institution (ECAI). Those ratings are used to determine the appropriate risk weights to determine the notional amount of the exposures.

Internal Capital Adequacy Assessment Process ('ICAAP')

The Group's own assessment of the levels of capital that it needs to hold through an examination of its risk profile from regulatory and economic capital viewpoints.

Internal Model Method ('IMM')

One of three approaches defined by Basel II to determine exposure values for counterparty credit risk.

Internal ratings-based approach ('IRB')

A method of calculating credit risk capital requirements using internal, rather than supervisory, estimates of risk parameters.

Interest rate risk in the banking book (IRRBB)

Interest rate risk in the banking book is the risk that the Group's earnings or economic value will decline as a result of changes in interest rates. The sources of interest rate risk in the banking book are:

- repricing risk (mismatch risk) [timing differences in the maturity (for fixed-rate) and repricing (for floating-rate) of bank assets, liabilities and off-balance-sheet positions];
- basis risk (imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics);
- yield curve risk (changes in the shape and slope of the yield curve); and
- embedded options risk (the risk pertaining to interest-related options embedded in bank products).

Invested capital

Equity capital invested in Absa by its shareholders.

IRB advanced approach

The IRB advanced approach is a method of calculating credit as risk capital requirements using internal PD, LGD and EAD models.

IRB foundation approach

The IRB foundation approach is a method of calculating credit risk capital requirements using internal PD models but with supervisory estimates of LGD and conversion factors for the calculation of EAD.

Liquidity risk

The risk that Absa does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows. Liquidity Risk is the risk that the Group is unable to meet its payment obligations when they fall due and to replace funds when they are withdrawn, the consequences of which may be the failure to meet obligations to repay depositors and to fulfil commitments to lend.

Loss given default ('LGD')

The estimated ratio (percentage) of the loss on an exposure to the amount outstanding at default (EAD) upon default of a counterparty.

Market risk

The risk that the Group's earnings or capital, or its ability to meet business objectives, will be adversely affected by changes in the level or volatility of market rates or prices such as interest rates, foreign exchange rates, equity prices, commodity prices and credit spreads.

Traded market risk – refers to market risk arising from the Group's trading activities.

Non-traded market risk – refers to market risk arising from the Group's banking book asset and liability management activities, notably interest rate risk in the banking book and minimal foreign exchange risk in the banking book.

Glossary

Mark-to-market approach

One of three approaches defined by Basel II to determine exposure values for counterparty credit risk.

Model risk

The risk that business decisions are made using model results that are incorrect. This includes the possibility of losing perspective of the limitations of models in general and the pitfalls associated with their use.

Non-performing loan

A loan is considered non-performing once its delinquency reaches a trigger point, which is typically when interest is suspended (in accordance with Absa's policy) or if the loan is moved to the legal environment for recovery. As a consequence, a loan that has defaulted is not necessarily non-performing (unless certain criteria are met).

Operational risk

The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.

Financial crime risk – Failure to monitor, report and act on financial crime exposing the Group to losses, penalties and reputation damage.

Financial reporting risk – Failure to monitor and report on statutory financial requirements in line with Group requirements, leading to penalties.

Tax risk – Failure to comply with tax laws and practice (or provide accordingly, where appropriate) leading to a financial loss and/or separate damage to reputation.

Legal risk – Exposure of the Group to legal risk arising from business not conducted in accordance with the applicable laws.

Operations risk – Failure to deliver the intended outcome, including business continuity, data management, process management, premises risk, sourcing, supplier and service management.

People risk – Failure to achieve the Group's business objectives owing to problems that may arise because of people issues.

Regulatory risk – Failure to comply with applicable financial services regulatory rules and regulations exposing the Group to penalties and reputation damage.

Technology risk – The risk of failure of technology to deliver secure IT services that provide critical business services.

Major change programme risk – Failure to control requirements relating to strategic and significant change.

Corporate responsibility risk – Failure to consider corporate and social responsibility (CSR) issues that could result in the Group suffering reputation damage, financial penalties and loss of credibility in the eyes of stakeholders.

Brand risk – Failure to understand, identify or subsequently manage developments that could negatively impact the Group or Barclays brands.

Private equity investments

Equity securities in operating companies not quoted on a public exchange, often involving the investment of capital in private companies or the acquisition of a public company that results in the delisting of public equity.

Probability of default ('PD')

The probability that an obligor will default within a one year time horizon.

Regulatory capital

The capital which Absa holds, determined in accordance with the requirements of the Banks Act and regulations relating to banks.

Residual value risk

Residual value risk relates to lease agreements and reflects the risk of when the lender buys back the asset at the end of the term at a pre-agreed (expected) value and the actual resale value is lower.

Residual maturity

The period outstanding from the reporting date to the maturity or end date of an exposure.

Retail IRB

Retail exposures that are treated under the IRB approach.

Risk appetite

The quantum of risk the Group is willing to accept in pursuit of its business strategy. Risk appetite is articulated from two perspectives: financial volatility and mandate and scale.

Risk-weighted assets ('RWAs')

Calculated by assigning a degree of risk expressed as a percentage (risk weight) to an exposure in accordance with the applicable standardised or IRB approach rules. Risk-weighted assets are determined by applying the following:

- advanced IRB approach for retail credit;
- foundation IRB approach for wholesale and corporate credit;
- AMA approach for operational risk;
- IMA for market risk;
- IRB market-based simple risk-weight approach for equity investment risk in the banking book; and
- standardised approach for all African entities.

Securitisation risk

The creation and issuance of tradeable securities, such as bonds, that are backed by the income generated by an asset, a loan, a public works project or other revenue source.

Special purpose entity

A corporation, trust or other non-bank entity, established for a narrowly defined purpose, including for carrying on securitisation activities. The structure of the entity and its activities are intended to isolate the obligations of the SPE from those of the originator and the holders of the beneficial interests in the securitisation.

Specialised lending

Specialised lending exposures are defined by the SARB as exposures to an entity which was created specifically to finance and/or operate physical assets, where the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate and the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.

Standardised approach

In relation to credit risk, a method for calculating credit risk capital requirements using ECAI ratings and supervisory risk weights.

In relation to operational risk, a method of calculating the operational capital requirement by the application of a supervisory defined percentage charge to the gross income lines.

Glossary

Strategic risk

Strategic risk is defined as the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, lack of responsiveness to industry changes and defective strategic planning. This risk is a function of the compatibility of an organisation's strategic goals, the business strategies developed to achieve these goals, the resources deployed against these goals and the quality of implementation.

Trading book

This comprises positions in financial instruments and commodities, including derivative products and other off-balance-sheet instruments that are held with trading intent or to hedge other elements of the trading book. It includes financial instruments and commodities that:

- are held for short-term resale; or
- are held with the intention of benefiting from short-term price variations; or
- arise from broking and market making; or
- are held to hedge other elements of the trading book.

Use test

Requirement that the components of advanced approaches for the calculation of regulatory capital should not be used merely for the calculation of regulatory capital. Instead they should play an essential role in how a bank measures and manages risk in its business.

Value at risk ('VaR')

A technique that measures the loss that could occur on risk position's as a result of adverse movements in market risk factors (e.g. rates, prices, volatilities) over a specified time horizon and to a given level of confidence.

Write-down

Reduction in the carrying value of an asset due to impairment of fair value movements.

Wrong-way risk

An adverse correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction.

Glossary

List of abbreviations

A

Abacas	Asset Backed Arbitrage Securities Proprietary Limited
ABB	Absa Business Bank
AbCap	Absa Capital
Absa	Absa Group Limited and/or Absa Bank Limited
ACRC	Absa Concentration Risk Committee
AEAR	Annual earnings at risk
AFS	Absa Financial Services/Available financial resources, depending on context/Annual Financial Statements
AGCC	Absa Group Credit Committee
AIA	Absa Internal Audit
AIRB	Advanced internal ratings based approach
ALCO	Group Asset and Liability Committee
ALM	Asset and liability management
AMA	Advanced measurement approach
AVAF	Absa Vehicle and Asset Finance
AVMS	Absa Vehicle Management Solutions (Pty) Limited

B

Barclays	Barclays PLC
Basel	Basel capital accord
BAU	Business as usual
BII	Basel II
BII.5	Basel II.5
BIII	Basel III
B-BBEE	Broad-based black economic empowerment
BCBS	Basel Committee on Banking Supervision
BSMCC	Balance sheet management and capital committee
BBM	Barclays Bank Mozambique
BFC	Board Finance Committee
BIA	Basic indicator approach
Bn	Billion
Bps	Basis points
BSMCC	Balance sheet management and capital committee
BSO	Balance sheet optimisation tool
BU	Business unit
BM	Business Markets

C

CAF	Countercyclical Adjustment Factor/Commercial Asset Finance, depending on context
CAPM	Capital Asset Pricing Model
CAR	Capital adequacy ratio
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CFLP	Contingency funding and liquidity plan
CI	Control issue
CIBW	Corporate, Investment Banking and Wealth
CIO	Chief Information Officer
CMC	Abcap Capital Management Committee
CMMC	Credit Risk Model Performance Monitoring Technical Committee
CNAT	Customer needs analysis tool
COE	Cost of equity
COO	Chief Operating Officer
CoRC	Absa Concentration Risk Committee
CPF	Corporate property finance
CREC	Credit risk economic capital
CRC	Credit Risk Committee/Concentration Risk Committee, depending on context
CRM	Credit risk mitigation
CRO	Chief Risk Officer
CRPF	Capital risk policy framework
CRTC	Credit Risk Technical Committee
CSA	Collateral support annexes
CT1	Core Tier 1
CVA	Credit value adjustment

D

DAF	Directors' Affairs Committee
dLGD	Downturn loss given default
DG	Default grade
DGC	Data Governance Council
DGO	Data Governance Organisation
DMTN	Domestic medium term note
DPS	Dividend per share
D-SIB	Domestically systematically important bank
DVaR	Daily value at risk

Glossary

E

EAD	Exposure at default
EBA	European Banking Authority
EC	Economic capital
ECAIS	External credit assessment institutions
ECM	Economic capital multiplier
EL	Expected loss
EMC	Executive Model Committee
EMTN	Euro medium term note
EP	Economic profit
ERBB	Equity risk in the banking book
EVE	Economic value of equity
EWL	Early warning watchlist
Exco	Absa Executive Committee
Excon	Exchange controls

F

FAIS	Act Financial Advisory and Intermediary Services Act
FCF	Free cash flow
FCTR	Foreign currency translation reserve
FI	Fixed income
FIRB	Foundation internal ratings based approach
FSA	Financial Services Authority (UK)
FSB	Financial Services Board (South Africa)
FTSE	Financial Times Stock Exchange
FX	Foreign exchange

G

GACC	Group Audit and Compliance Committee
GCC	Group Credit Committee
GCE	Group Chief Executive
GDP	Gross Domestic Product
GEC	Group Executive Committee
GGCC	Group Governance and Control Committee
GIC	Group Investment Committee
GIOC	Group Integration Oversight Committee
GRCMC	Group Risk and Capital Management Committee
GRHRC	Group Remuneration and Human Resources Committee
GRPR	Group risk profile report
GSF	Group specialist function
GTC	Group Tax Committee

H

HEPS	Headline earnings per share
HR	Human resources

I

IAS	International Accounting Standards
IAR	Integrated Annual Report
ICAAP	Internal capital adequacy assessment process
ICR	Incremental risk charge
IDRC	Incremental default risk charge
Ig-Cg	Income growth-Cost growth
IFRS	International Financial Reporting Standard
IMA	Internal model approach
IRB	Internal ratings based approach
IRMP	Information Risk Management Policy
ISDA	International Swaps and Derivative Association
IRRBB	Interest rate risk in the banking book
IT	Information technology
ITSC	Information Technology Steering Committee

J

JLOC	Johannesburg Loan Operating Committee
JIBAR	Johannesburg Interbank Agreed Rate
JSE	Johannesburg Stock Exchange

K

KI	Key indicator
KMV	Moody's KMV (Kealhofer, McQuown and Vasicek) portfolio manager
KRI	Key risk indicator
KRS	Key risk scenarios

Glossary

L

LCR	Liquidity coverage ratio
LGD	Loss given default
LTV	Loan to value

M

m	million
MAG	Maximum allocation guideline
MCL	Maximum cumulative loss
MDA	Model and Data Assurance
MI	Management information
MDM	Master Data Management
MLE	Maximum likelihood estimate
MPL	Maximum probable loss
MPC	Monetary Policy Committee
MRC	Market Risk Committee
MRP	Model Risk Policy
MTM	Mark-to-market
MTP	Medium-term plan
M&A	Merger and acquisition

N

NAV	Net asset value
NBFI	Non-bank financial institution
NBC	National Bank of Commerce Limited (Tanzania)
NCD	Negotiable certificate of deposit
NGE	Net generated equity
NPL	Non-performing loan
NSFR	Net stable funding ratio

O

OTC	Over-the-counter
ORC	Operational Risk Committee

P

PBT	Profit before tax
P&L	Profit and loss
PD	Probability of default
PE	Property and equipment
PIT	Point in time
PMA	Post-model adjustment
PMAC	Post-Model Adjustment Committee
PRO	Principal risk owner
PRP	Principal Risks Policy

Q

QD	Quantile difference
QIS	Quantitative impact studies

R

RAF	Revised annual forecast
RAFDA	Risk and finance data alignment
RAR	Risk adjusted remuneration
RBB	Retail and Business Banking
RC	Regulatory capital
RCA	Risk and control assessment
RCRC	Retail Credit Risk Committee
Regulations	The SARB regulations relating to banks
ROA	Return on assets
ROE	Return on equity
RoEC	Return on economic capital
RORAC	Return on risk adjusted capital
RORC	Return on regulatory capital
RoRWA	Return on risk weighted assets
RWA	Risk weighted assets
RSA	Republic of South Africa

S

SA	South Africa/standardised approach, depending on context
SAM	Solvency Asset Management
SARB	South African Reserve Bank
SBTR	Share based payment reserves
SIFIs	Systemically important financial institutions
SME	Small and medium enterprises
SOX	Sarbanes-Oxley
SREP	Supervisory review and evaluation process
STP	Short-term plan

Glossary

S

SWOT	Strengths, weaknesses, opportunities and threats
SPE	Special purpose entity

T

TRC	Trading Risk Committee
TSA	The standardised approach
TTC	Through the cycle

U

UL	Upper limit/Unexpected loss, depending on context relating to banks

V

VAPM	Value added performance measurement
VaR	Value at risk
VAS	Value at stake
VBM	Value based management

W

WD	Work day
WFS	Woolworths Financial Services Proprietary Limited
WCRMC	Wholesale Credit Risk Management Committee

X

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Y

YEA	Year end actual
YTD	Year to date

Z

ZAR	South African Rand

Disclaimer

Forward-looking statements

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