Reflecting on issues affecting us

Introduction

Absa's success depends on how well we respond to the needs of society in general and the communities we serve. The foundations of our long-term sustainability are the strength of our relationships, the quality of our resources and how effectively we are able to leverage them to the best advantage of all our stakeholders, and in particular our customers and shareholders.

In considering the issue of sustainability in more detail, we have distilled a high-level list of five (previously 12) material issues that serve as a framework to develop our strategy. These are sustainable financial viability, process and systems effectiveness, customer experience, our people and economic equity. Maria discusses in her review the progress relative to our One Absa strategy and our performance against each of these issues.

In our 2011 integrated annual report, we have set out the story of Absa for the year, noting key positives and negatives. I hope you will find it useful in better understanding our performance, opportunities and challenges. I will touch on a few key issues in my introduction. Further detail can be found in later chapters and online.

As Absa's Chairman, I am particularly concerned with how we respond to the material issues we have identified. In this regard, the governance of our decision-making process and our behaviour is critical, and I will refer to the principles that underpin our leadership's remuneration and the values that guide our behaviour.

Operating environment

Turmoil in international markets

We are experiencing uncertain times. Concerns about the future of Europe and the Euro and the debt impasse in the US, are fuelled by subdued growth in local consumer spending as the world works off the excesses of the past 25 years in both the public and private sectors. Stresses are also to be found in China and India, ensuring that uncertainty is not limited to the developed world. While we are naturally concerned about the effects of this uncertainty on international and domestic economic growth, our direct exposure to international markets is limited. We carefully monitor developments both directly and through Barclays, which provides our risk management processes with timely and pertinent insights.

South Africa in an African context

In the aftermath of the global slowdown, Africa has emerged as an attractive growth opportunity. Some of the poorest economies are now showing the fastest growth – basic infrastructure such as roads and cellular networks are being developed and citizens now have the opportunity to benefit from the advantages of the modern information-based economy.

South Africa looks northwards with some expectation, and rightly so, as we have much to offer and the opportunities are significant. These opportunities are not without their challenges, however, and we are very mindful of how different countries present their own political, regulatory, cultural and competitive environments.

South African environment

Although the supply side of economy lagged the demand side, South Africa recorded ten successive quarters of growth since the

We have paid careful attention to underlying principles of how we operate, from strengthening our governance and ethics management, reviewing our remuneration practices, to how we engage and respond to our stakeholders. These are critical foundations for our sustainability and future growth.

Garth Griffin Group Chairman

recession of 2009. The slowdown in the supply side of economy during 2011 was reflective of industrial action and a general slowdown of economic activity and a resultant reduction in GDP growth. The consumption-side of the economy remains the backbone of GDP growth, with robust vehicle sales and positive retail sales momentum continuing to reflect high wage settlements, manageable inflation and low interest rates. While household debt to disposable income has receded in the past year, the consumer remains highly indebted and the fear of job losses in a tough economic environment reduces confidence. As a result, consumers remain cautious about taking up new debt as evidenced by the subdued growth in credit extension to households. Growth in credit extension to the corporate sector was also subdued, and banking industry statistics reflect muted demand for credit at an aggregate level, notwithstanding the period of low and stable interest rate levels we have enjoyed. Fortunately, investment by the public sector continues to contribute to overall fixed investment growth, and we welcome the commitment to continued infrastructure development in the President's recent State of the Nation address and in this year's budget statement.

Critically, we need some certainty on the policy framework within which government operates. There is much to be said for vibrant and robust debate about policy options, especially when so much of economic orthodoxy has been found wanting in the recent past, as evidenced by the many issues faced by much of the so called 'developed world'. The challenges raised by 'job free' growth, rapidly rising youth unemployment and growing income inequalities – issues that are not limited to South Africa – demand creative and bold thinking. However, neither can we afford endless debates nor yet another proposed plan. It is incumbent on government to establish a framework, supported by coherent policies and legislation, within which the talents of 50 million South Africans can be harnessed for the benefit of all. Clarity will bring focus and, in turn, positive momentum so crucial to long-term growth.

To this end, we view the National Development Plan (NDP) as a major opportunity to both forge a common vision about what the country can become and to establish a set of key initiatives that can guide policy and decision-making as we pursue the fundamental goal of reducing both poverty and inequality.

Key points

- Uncertainty in international markets
- Local economy remains subdued as Africa gathers momentum
- Technology drives innovation and access
- Regulatory environment remains complex and demanding
- Sound ethical behaviour and robust governance are key to sustainability

Outlook

- Well positioned for emerging opportunities, including Africa
- Strong capital foundation provides base for growth
- Continued focus on our corporate citizen agenda
- Ongoing regulatory developments unlikely to abate
- The National Development Plan promises a credible framework for future policy

Strategic pillars discussed

Competitive environment

South Africa has a vibrant and competitive banking industry. Consumers have the choice of both service provider and the type of service they seek. We welcome this, underpinned as it is by access to technology. Technology is revolutionising the way in which consumers can access banking services and enabling products and services that would otherwise not have been affordable. Absa has embraced this development and seeks to remain at the forefront of technological developments – a number of our successes are noted elsewhere in our report.

However, these developments also introduce new risks into the system. At the macro level, we remain concerned by the opportunity for regulatory arbitrage, while at the micro level, we remain vigilant in defending Absa and our customers from electronic fraud. Overall, these challenges keep us focused on improving our service offering and ensuring a solid foundation for careful expansion.

Competitively, the information economy places high demands on our business. Continuous innovation is required to meet rapidly developing consumer preferences, a trend not limited to banking, while at the same time it is essential to provide robust and resilient operational capabilities. So we continue to invest in IT. Clearly our business survives because of the quality of our people, in terms of their technical ability and their willingness to serve customers, irrespective of their role. Two of our biggest focus areas therefore remain the quality of our IT systems and the war for talent.

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Regulatory environment

The regulatory environment in which we function is a complex and rapidly changing one, as regulators respond to challenges at both the prudential and consumer level. The task facing regulators is not an easy one, as they have to balance the need for financial stability against the fundamental role played by financial institutions in general, and banks in particular, within the global and national financial systems. As we have seen, overemphasis on capital requirements can lead to undesirable impacts on the extension of credit. At the same time, regulators have also to ensure that the financial sector deals fairly with its customers. To further complicate matters, the financial services sector plays an important role in combating money-laundering and other illegal activities. This all leads to a complex array of regulatory requirements and new developments. The investment required to respond appropriately is significant.

The regulatory structure in South Africa is also undergoing change. National Treasury proposed the twin peaks model (also used in Australia, Canada and the Netherlands with similarities to the direction being taken in the UK) in a document released in February 2011. The model separates the regulation of market conduct by all financial institutions, including banks and insurers, from their prudential supervision. Under the "twin peaks" model, market conduct will be regulated by the Financial Services Board (FSB), while the Reserve Bank will provide prudential oversight. The Treasury believes the new system will result in tighter regulation, better consumer protection and a safer financial sector, and there is much to commend this view. A number of bills are planned to be submitted to Parliament in 2012 to give effect to this change, all of which will demand careful scrutiny.

With regard to prudential supervision, Basel III is the key development for banks, while insurers are dealing with the development and imminent introduction of the local version of the EU Solvency II prudential framework, called Solvency Assessment and Management (SAM). The local banking industry in general and Absa in particular, are well positioned to accommodate the higher capital levels required, and the improved mix of available capital. We do not have the issues faced by many overseas banks with regard to both the quantity and the quality of their capital base. However, the liquidity demands of Basel III are a challenge in the context of the South African and other emerging markets and we look forward to guidance from the Reserve Bank in this regard. Elsewhere in our report, you will note the pleasing progress made by Absa in growing our surplus liquid assets and lengthening the maturity profile of our deposits.

New developments on the consumer front include the Consumer Protection Act, which came into effect on 1 April 2011, and the Treating Customers Fairly (TCF) discussion paper, published by the FSB in 2010 aimed specifically at the financial services industry. As a member of the Barclays Group, Absa has already adopted a set of TCF principles similar to those applicable in the United Kingdom and is therefore well placed to respond quickly to local requirements. Following the inquiry by the Competition Commission into banking fees in 2006, we have fully endorsed and implemented the banking industry commitments to, amongst other measures, improve customer education, introduce a switching code, reducing certain penalty fees and participate in revising the Code of Banking Practice. Customer education has been a particular focus for Absa, and we are convinced that this is to the benefit of the country as a whole.

While one has a measure of sympathy for the regulatory authorities, as they have to respond to both international developments and local emerging imperatives, care needs to be taken with the volume and complexity of regulatory change. Unintended consequences may emerge, including opportunities for regulatory arbitrage. What is certain is that there is evidence of overload and fatigue in this domain, and a period of stability and consolidation would be welcomed.

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The risk environment

Depending on one's perspective, one could describe the current risk environment as either benign, with signs of improved consumer confidence and ability to meet debt obligations, or uncertain, with dark clouds remaining on the horizon due, mainly, to uncertain economic growth prospects. As we would be ill advised to claim any certainty about future events, it seems sensible to remain cautious, responding to the green shoots as appropriate, but at the same time, ensuring a resilience that provides protection should conditions deteriorate.

With this in mind, we placed a strong focus on developing our stress scenarios in conjunction with our Barclays colleagues. Not only do these scenarios attempt to assess the potential impact of various sets of events, but they also provide some early warning indicators and help us to identify management actions that can mitigate the impacts as events unfold. Given our inability to predict with certainty, being prepared and sufficiently flexible to take early action is our preferred response.

Looking back, 2011 was a year in which we:

- consolidated and enhanced our internal risk management processes, including our stress testing;
- further improved our liquidity position;
- experienced an improvement in our credit risk exposure and experience;
- advanced our internal operational risk management processes and environment; and
- limited our market and equity risk exposures.

This helped to enable a thorough evaluation of the amount of capital deemed necessary to retain and informed the sharp increase in the dividend announced for the year. In line with the principle of retaining flexibility to respond to emerging circumstances, our approach to dividend levels will continue to be driven by a careful assessment of appropriate capital levels and other business metrics, from time to time, rather than a fixation with a particular dividend cover ratio.

The environment in 2011 proved relatively benign from a South African perspective, as we are largely shielded from the turmoil of international markets. I think the key challenge for 2012 will be to sustain this favourable position and to take advantage of the foundation this provides for specific, value-adding opportunities.

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Stakeholder engagement

In the year under review, we gave particular attention to formalising our stakeholder engagement. It is, after all, through interacting with our stakeholders that we become aware of concerns, risks and opportunities. By mapping this engagement, we have been able to consolidate this vital feedback and identify areas where we are possibly not deriving the best business intelligence from our stakeholders.

See page 18 for a review of our stakeholder engagement and key matters identified.

I would like to dwell for a moment on two key stakeholder groups – our customers and our people.

Customers

We recognise that our customers are emerging painfully from the economic crisis of 2008. In aggregate, consumers are paying off debt and the corporate market is loath to commit to invest in growth opportunities, given the uncertainty prevalent in the environment.

With wealth gaps in all our markets continuing to widen, we recognise that the economic system is not catering sufficiently for the economically disenfranchised. In this regard, we align ourselves with the National Development Plan vision document that states that "it is possible to eliminate poverty and to sharply reduce inequality by 2030".

We hope to play a constructive role in enabling this outcome. Key roles that we can and will play include introducing affordable basic financial services to the largely unbanked sector, consumer education, supporting small enterprises in their emerging business ventures, and assisting to restore the financial health of those in distress.

Within the corporate sector, too, customer needs are changing. Ongoing margin pressures, heightened competition and growing degrees of multinational expansion demand more sophisticated banking services that add value to customers. Responding effectively to these needs is a key focus of ours.

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Our people

I am acutely aware of the challenges that our employees face as we serve our customers in today's environment. Regulatory requirements demand intensive training; cost and margin pressures demand more accountability and greater productivity; system and process changes – due to product and service adaptations or innovation – require learning new information and often require changes to work routines. Throughout the year, our people have responded admirably to the various challenges that have come their way.

We have to continue nurturing and retaining talent. Developing our people takes the form of both training and providing career opportunities. We carefully monitor our mix of promotions, performance ratings and salary adjustments, by both gender and race. The challenge to meet transformation targets is real, but we remain committed to our targets and playing our role in transforming South Africa's workforce.

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How we respond – values and ethics, governance, and remuneration

The sustainability of the financial results we achieve in meeting the goals of our One Absa strategy depends on how we behave and the way we conduct ourselves in our business dealings – our corporate climate or culture. Our five core values of leadership underpin how we behave at every level, and much was done over the year to reinforce these values. Dealing as we do with customers' money, ethical behaviour is critical, as is sensitivity towards the needs of the underprivileged within the communities we serve.

An important aim of this report is to show the direct link between society's concerns (encapsulated in our material issues) and the quality of our stewardship in the decisions we make. Governance and remuneration are key aspects determining how effectively we fulfil these duties.

Ethics

As a financial institution, ethical behaviour underpins the trust placed in us by our customers and is thus a non-negotiable element of the way in which we behave and conduct ourselves. We have in place a formal framework and sets of policies that are regularly reviewed, but it is actual behaviour that is ultimately important. Significant progress was made in embedding awareness and appreciation of ethical behaviour within Absa via specific educational and communication programmes. The board leads in this regard, and a regular review of behaviour and attitudes is a key item on the agenda of the new Social and Ethics Committee.

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Governance

We have a formalised structure for governing the business – how we make decisions and how we hold ourselves accountable for our actions. Absa's board of directors is the foundation of corporate governance in the Group and oversees processes that ensure sound ethics in all our dealings with stakeholders. The Directors' Affairs Committee is the appointed board subcommittee advising the board on governance matters.

Both the new Companies Act of 2008 and King III became formally applicable in 2011, and various teams have worked to ensure that we comply with the new Act and King III recommendations. As a subsidiary of Barclays Bank PLC, we also take cognisance of its governance requirements as set out in the UK Corporate Governance Code. Other key governance developments over the year included:

- establishing an appropriate governance process for information technology (IT), including board-level oversight;
- establishing a Group Social and Ethics Committee, in compliance with the Companies Act;
- conducting a review of board effectiveness, facilitated by an independent external party. The review found that the board functions well and key aspects of the findings are in the corporate governance section of this report; and
- developing a framework for reporting key sustainability issues more effectively; work still needs to be done, on a broad-based, integrated stakeholder engagement process.

Absa has been recognised for its governance, social and environmental activities through its inclusion in the 'Best Performer' category of the JSE's Social Responsibility Index for the fifth consecutive year, one of only six JSE-listed companies to receive this recognition.

I believe that, over the year, we have succeeded in further improving our corporate governance framework, and our relationship with Barclays has been of great value in this regard. This is, of course, an ongoing journey, but one that is vital to our success.

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Executive remuneration

Executive remuneration is an important and very emotive issue. Articles on this topic frequently refer to the lack of effective governance and the unwillingness (or worse) of non-executive directors to stem the tide of perceived excesses in this regard. The banking sector is usually singled out for particular criticism. Against this backdrop, remuneration governance received specific attention. Over the year, we refined our remuneration policy, with assistance from Barclays, and developed a policy embedding the following key principles:

- There must be a clear framework for assessing the share of value to employees relative to shareholder earnings.
- Incentive payments must be determined based on clear performance objectives; these are not always captured in metrics and some degree of subjectivity will always be necessary in assessing executive performance.
- Deferrals, with claw back provisions and linked to share price performance, should be an important element of incentive awards. While not perfect, this mitigates against undue focus on short-term performance.
- Overall packages must be competitive; talent is mobile, both within local markets and globally.
- Reporting on remuneration must be transparent and provide clear insight into the decisions made in this regard.

Our remuneration report elaborates on this and, I trust, illustrates these principles in action. It is going to be very difficult, if not impossible, to satisfy all the critics, but our objective remains to remunerate and incentivise our employees in a manner that is fair and competitive, and disclosed with appropriate transparency.

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Strategy development and delivery

As mentioned, our business strategies are developed on the foundation of our values and governance structures and within the framework of our material issues. Strategy development and implementation is driven and managed by the executive team, under the guidance of the Group Chief Executive. Her review, as well as the other sections of the IAR, provide further detail on our progress against our strategy to date. Our results bear testimony to the effective implementation of our One Absa strategy.

Relationship with Barclays

The past year saw the further development of our beneficial working relationship with our majority shareholder, Barclays. We will continue to draw on Barclays expertise to strengthen the business. Fortunately, the transfer of knowledge is not just a one-way process; Absa has also contributed some of its know-how and developments to Barclays. We thank our colleagues in Barclays for their support and look forward to growing this mutually beneficial relationship.

Board changes

On 21 September 2011, Ivan Ritossa replaced Benoît de Vitry as a Barclays representative non-executive director. Peter Matlare was appointed to the board as an independent director on 5 December 2011.

Des Arnold and Monhla Hlahla retired at the annual general meeting on 21 April 2011. Brian Connellan will retire at the 2012 AGM after serving 18 years on the board of Absa. In every respect, Brian was an outstanding non-executive director with a deep understanding of the business and his contribution will be missed. We wish Brian and Merle, his wife, well.

As advised in our announcement on 14 March, I intend standing down from the board as soon as a successor is in place. It has been a privilege to serve on the Absa board for the past 11 years and I am confident that the Group is well positioned to further develop the benefits of its relationship with Barclays and to grow its contribution to the communities it serves.

Acknowledgements

I would firstly like to thank my colleagues on the board for their contribution over the past year. The role of a bank non-executive director is demanding, but their commitment and application has been exemplary.

Secondly, I would like to acknowledge the leadership provided by our Group Chief Executive, Maria Ramos. She has managed the myriad of demands and the challenges of the role in an exceptional fashion, and sets an impressive example for the leadership group. She is ably supported by Louis von Zeuner, David Hodnett and other members of the Group Exco. Thank you all for your leadership and dedication.

Thank you also to the broader group of employees for your contribution to a successful year. I trust that you will continue to be motivated by the satisfaction of serving the communities where we operate in such a meaningful fashion, whether directly or indirectly, and the opportunities for the personal development that the Group offers.

Finally, I would like to thank our various regulators for their constructive engagement over the year. In particular, I would like to congratulate Mr Rene van Wyk on his appointment as Registrar of Banks at the South African Reserve Bank. He succeeds Mr Errol Kruger, who made a major contribution to the South African banking sector during his tenure. We wish him well as he settles in to a demanding role and look forward to working with him and his team.

In conclusion

2011 was a challenging year – we've done well, all things considered. 2012 is unlikely to be any less challenging. We will continue to invest in capacity and our people to better serve our customers, develop the communities we serve and expand our reach in a responsible and sustainable manner. Ultimately we trust this will lead to satisfied stakeholders and, in particular, superior rewards for our shareholders.

Garth Griffin

Group Chairman

28 March 2012