

Risk management and control

Group risk management philosophy

The Group recognises that the business of banking and financial services is conducted within an environment of complex inter-related risks. The Group operates in a dynamic environment where the past is not necessarily an acceptable guide to the future. Risk management is a key focus of the Group and addresses a wide spectrum of risks that are continually evaluated and policies and procedures reviewed to adapt to changing circumstances. In any economy there are sectors that are more vulnerable to cyclical downturn than others. Economic variances are monitored to assist in managing exposure to such sectors. The concentration of risk in our target market sectors is managed to achieve a balanced portfolio. Our business development efforts are focused on the stronger companies and individuals, establishing policy criteria, which eliminate weaker credit or investments from the portfolio. A passive role in the face of potential or actual adverse conditions is not accepted.

A philosophy of enterprise-wide risk management within a Risk Management Monitoring and Control Framework has been established to ensure that all business and operational risks are managed effectively within acceptable risk profiles, policies and parameters. The management of risk is an independent process from that of taking on/creating risk within the Group. Risk management policies are essentially conservative, with proper regard to the mix of risk and reward. The Group will take all necessary steps to safeguard its depositors' funds, its own asset base and shareholders' funds.

Enterprise-wide risk management

An Enterprise-wide Risk Management Framework is adopted to ensure appropriate and focused management of all risks. Risk assessment is a dynamic process and is reviewed regularly. Risk dimensions will vary in importance based on the business activities of an organisation. The overall objective of enterprise-wide risk management is to ensure an integrated and effective risk management framework, where all risks are identified, quantified and managed in order to achieve an optimal risk reward profile. The presence of accurate measures of risk makes risk adjusted performance possible, creates the potential to generate increased shareholder returns and allows the risk taking behaviour to be more closely aligned with our strategic objectives.

Risk management is performed on a Group wide basis involving the Board, credit management, senior management, independent risk management, business line management, finance and control, legal/compliance, treasury and operations, with significant support from internal audit and information technology.



Risk management life cycle/process

All of the Group's policies and procedures manuals have been reviewed and signed off by the relevant divisional heads. These standards are an integral part of the Group's governance infrastructure and risk management profile, reflecting the expectations and requirements of the Board in respect of key areas of control. The standards ensure alignment and consistency in the way that prevalent risk types are managed and form part of the four phases of the risk management life cycle, defined as:

Risk management and control (continued)

Risk management life cycle/process (continued)

Risk identification (and comprehension)

Risk identification focuses on recognising and understanding existing risks or risks that may arise from positions taken and future business activity as a continuing practice.

Risk measurement (and evaluation using a range of analytical tools)

Once risks have been identified, they need to be measured. Certain risks will obviously lend themselves more easily to measurability than others, but it is necessary to ascertain the magnitude of each risk.

Risk management (as an independent function)

The Group's principal business focuses on the management of liabilities and assets in the balance sheet. Major risks are managed and reviewed by an independent risk function. The ALCO and RMC meet on a regular basis to collaborate on risk control, establish how much risk is acceptable and decide on how the Group will stay within targets and laid down thresholds.

Risk monitoring (and compliance with documented policies)

Open, two-way communication between the Group and the South African Reserve Bank ("SARB") is fundamental to the entire risk monitoring and supervisory process. To achieve this, responsible line heads are required to document conclusions and communicate findings to the ALCO and RMC in the first instance and to the SARB via the Finance Division through DI returns and periodic meetings.

Management of risk

Principal risk categories have been identified, defined and categorised into direct and indirect risks. This set of risk definitions forms the basis of management and control relative to each division within the Group and also forms a consistent common language for outside examiners and/or regulators to follow.

Direct risks are found in most banking transactions. They are quantifiable and can be clearly defined. These risks are evaluated through examination of our databases, statistics and other records.

Indirect risks are considered to ensure that a complete risk assessment is carried out. They are present in almost every decision made by management and the Board and thus impact on the Group's image and success. These decisions are usually intended to enhance the Group's long-term viability or success and therefore are difficult to quantify at a given point in time.

Board Committees monitor various aspects of the different identified risks, which include:

Direct Risks	Indirect Risks
Credit Risk	Strategic Risk
Counterparty Risk	Reputation Risk
Currency Risk	Legal Risk
Liquidity Risk	Fraud Risk
Interest Rate Risk	International Risk
Market (Position) Risk	Political Risk
Solvency Risk	Competitive Risk
Operational Risk	Pricing Risk
Technology Risk	Sensitivity Risk
Compliance Risk	

The responsibility for understanding the risks incurred by the Group and ensuring that they are appropriately managed lies with the Board. The Board approves risk management strategies and delegates the power to take decisions on risks and to implement strategies on risk management and control to the RMC. Discretionary limits and authorities are in turn delegated to line heads and line managers within laid down parameters to enable them to execute the Group's strategic objectives within predefined risk management policies. Major risks are managed, controlled and reviewed by an independent risk function.

Risk management and control (continued)

Management of risk (continued)

The Board fully recognises that they are accountable for the process of risk management and the system of internal control. Management reports regularly to the Board on the effectiveness of internal control systems and significant control weaknesses identified.

A process is in place whereby the Top 10 risks faced by the Group are identified. These risks are assessed and evaluated in terms of a risk score attached to inherent risk and residual risk. Action plans are put in place to reduce the identified inherent risks to within acceptable residual risk parameters. The Top 10 risks are re-evaluated quarterly.

Focus has been increased on the overall improvement in the management of credit and counterparty risk through the implementation and ongoing development of a comprehensive on-line Early Warning Risk Identification System together with a Risk Assessment Decision Support Tool.

Increased focus has also been placed on Business Continuity Management ("BCM") during the year under review. BCM ensures the availability of key staff and processes required to support essential activities in the event of an interruption to, or disruption of, business. BCM is an important aspect of risk management and its value has been proven in creating a more resilient operational platform, through activities such as business impact assessments, business continuity planning and implementation, testing of business continuity and implementing corrective actions. Comprehensive simulations are conducted on an ongoing basis, with identified gaps addressed and/or plans put in place to resolve the identified issues.

Further enhancements have been made in the management of the Group's assets and liabilities with increased monitoring of liquidity and interest rate risk through sensitivity evaluation and forecasting techniques. An internally developed Management Information System was enhanced during the year under review to improve the quality of internal reporting.

During the year under review, the Group established a Capital Management Committee under the auspices of the RMC to proactively evaluate and manage the Capital requirements of the Group as determined by Basel II requirements.

Under the Enterprise-wide Risk Management Framework we have categorised the direct risks of the Group and report on those deemed to be of the most significance:

Credit risk

Credit parameters and tolerance levels are clearly defined and reflected in governing procedures and policies. The Group offers a spread of banking products common within the banking industry with a specific focus on small and medium sized businesses across a wide variety of industries. Whilst personal market products are also offered, no specific targeting of the broader personal retail based market is undertaken. The primary risks encountered are associated with the lending of money and the issuing of contingent financial or performance guarantees to third parties on behalf of customers.

Dependent upon the risk profile of the customer, the risk inherent in the product offering and the track record/payment history of the client, varying types and levels of security are taken to mitigate credit related risks. Clean or unsecured lending will only be considered for financially strong borrowers.

Counterparties to derivatives expose the Group to credit-related losses in the event of non-performance. The counterparties to these contracts are financial institutions. The Group continually monitors its positions and the credit ratings of its counterparties and limits the amount of contracts it enters into with any one party.

At year-end, the Group did not consider there to be any significant concentration of risk, which had not been insured or adequately provided for. There were no material exposures in advances made to foreign entities at year-end, except for the deposits placed with CGD as disclosed in note 28.2.

A portfolio analysis report is prepared and presented to the RMC analysing the performance and makeup of the book including customer and segment concentration analyses.

Risk management and control (continued)

Management of risk (continued)

Credit risk (continued)

The Group has adopted a conservative approach to credit granting within a specifically defined and structured approval process. The granting of credit is managed via a mandated approval process whereby levels of credit approval are determined by the experience of the mandated individual with dual or multiple sign-off on all material values. An ongoing weekly review is also undertaken by the CREDCOM of all lending in excess of R1 million. In addition the early warning system is applied to actively manage all accounts within the risk structure. The system identifies a number of characteristics relating to the performance of the accounts and based on various predefined algorithms, flags issues of concern. Monitoring is done by the Early Warning Department and any concerns are raised with the Credit Department and Retail or Commercial banking units. The Group is in the process of further developing a Decision Support tool to assist credit decision makers through the provision of indicative performance criteria and other information necessary to assist in making increasingly informed decisions. Such indicative performance data will be measured against predefined acceptance bands and result in the allocation of an overall acceptability rating.

There have been no material changes in the credit approval structure or overall make-up of the book from the prior reporting period.

The table below summarises the Group's maximum exposure to credit risk at balance sheet date:

	Loans and advances R'000	Committed undrawn facilities R'000	Other R'000	Total R'000
2007				
Current accounts	780 463	–	–	780 463
Credit card	21 555	32 679	–	54 234
Mortgage loans	1 241 399	190 910	–	1 432 309
Instalment sales and leases	304 588	–	–	304 588
Other advances	562 401	–	–	562 401
Guarantees	–	–	391 335	391 335
Letters of credit	–	–	19 937	19 937
	2 910 406	223 589	411 272	3 545 267
2006				
Current accounts	448 290	–	–	448 290
Credit card	29 002	–	–	29 002
Mortgage loans	711 221	269 478	–	980 699
Instalment sales and leases	299 284	–	–	299 284
Other advances	680 186	–	–	680 186
Guarantees	–	–	269 402	269 402
Letters of credit	–	–	11 662	11 662
	2 167 983	269 478	281 064	2 718 525

Operational risk

Operational risks faced by the Group are extensive and inter alia include risks associated with reputation, robbery, fraud, theft of data, legal challenges, statutory and legislative compliance, operational processes, employment policies, documentation risk and business continuity. Strategies, procedures and action plans to monitor, manage and limit the risks associated with operational processes, systems and external events include:

- documented operational policies, processes and procedures with segregation of duties;
- training and upskilling staff on operational procedures and legislative compliance;
- an operational event logger wherein all losses associated with operational issues including theft and robbery are recorded and evaluated to facilitate corrective action;
- ongoing improvements to the Disaster Recovery and Business Continuity plans including conducting a variety of simulation exercises in the branches and critical operations environments; and

Risk management and control (continued)

Management of risk (continued)

Operational risk (continued)

- conducting a variety of internal audits and reviews by both the Compliance and Internal Audit Departments in line with annual plans approved by the Board.

There have been no material losses during the reporting period that require specific identification.

Market risk

Market risk is the risk of revaluation of any financial instrument as a consequence of changes in market prices or rates and can be quantified as the potential change in the value of the banking book as a result of changes in the financial environment between now and a future point in time.

The Board determines market risk limits. These limits are reviewed at least annually dependent on market events.

The Group does not currently have any proprietary trading positions and therefore has minimal exposure to market risk. Before the Group enters into a proprietary trading position, the Trading Committee will evaluate and approve such positions. This Committee will ensure that the Group is prudently positioned, taking into account agreed limits, policies, prevailing markets, available liquidity and the relationship between risk and reward primarily to the financial risks of changes in foreign currency exchange rates and interest rates. The Group enters into derivative financial instruments to manage its exposure to interest rate and foreign currency risk, including:

- forward exchange contracts; and
- interest rate and foreign currency swaps.

Detailed market risk reports are produced on a daily basis, which allows for monitoring against prescribed limits. In the unlikely event of an unauthorised limit violation, the Asset and Liability Management Forum ("ALM") records such violation, which is immediately corrected and reported to the ALCO, which is a subcommittee of the RMC.

The Group does not perform a detailed sensitivity analysis on the potential impact of a change in exchange rates due to the fact that the Group does not currently have any proprietary trading positions. A detailed sensitivity analysis is performed for liquidity and interest rate risk as described below.

There has been no significant change to the Group's exposure to market risks or the manner in which it manages and measures the risk.

Foreign currency risk

The Group, in terms of approved limits, manages short-term foreign currency exposures relating to trade imports, exports and interest flows on foreign liabilities.

The Group has conservative limits in terms of net open foreign currency positions which are well below the limits allowed by the South African Reserve Bank. For the year under review the highest net open position recorded for any single day was R5.1 million.

Risk management and control (continued)

Management of risk (continued)

Foreign currency risk (continued)

The transaction exposures and foreign exchange contracts at balance sheet date are summarised as follows:

	US Dollar R'000	Euro R'000	Pound Sterling R'000	Other R'000	Total R'000
2007					
Total foreign exchange assets	913 287	65 356	30 444	8 116	1 017 203
Total foreign exchange liabilities	(60 493)	(18 578)	(20 794)	(89)	(99 954)
Commitments to purchase foreign currency	245 343	67 736	20 242	8 320	341 641
Commitments to sell foreign currency	(1 097 925)	(114 958)	(30 513)	(16 640)	(1 260 036)
Year-end effective net open foreign currency positions	212	(444)	(621)	(293)	(1 146)
2006					
Total foreign exchange assets	1 459 295	37 348	28 834	4 285	1 529 762
Total foreign exchange liabilities	(24 402)	(10 890)	(22 193)	(329)	(57 814)
Commitments to purchase foreign currency	153 361	61 023	4 753	12 827	231 964
Commitments to sell foreign currency	(1 588 540)	(87 718)	(11 911)	(16 601)	(1 704 770)
Year-end effective net open foreign currency positions	(286)	(237)	(517)	182	(858)

Interest rate risk

Interest rate risk is the impact on net interest earnings and the sensitivity to economic value as a result of increases or decreases in interest rates arising from the execution of the core business strategies and the delivery of products and services to customers. Interest margins may increase as a result of such changes, but may reduce or create losses in the event that unexpected adverse movements arise. The ALM forum monitors interest rate repricing on a daily basis and reports back to the ALCO and RMC.

The Group is exposed to interest rate risk as it takes deposits from clients at both fixed and floating interest rates. The Group manages the risk by maintaining an appropriate mix between fixed and floating rate funds and by the use of interest rate swap contracts.

Under interest rate swap contracts, the Group agrees to exchange the difference between fixed and floating rate interest amounts calculated on agreed notional principal amounts. Such contracts enable the Group to mitigate the risk of changing interest rates on the fair value of issued fixed rate debt and the cash flow exposures on the issued variable rate debt. The interest rate swaps reprice on a quarterly basis. The floating rate on the interest rate swaps is based on the three-month JIBAR. The Group will settle the difference between the fixed and floating interest rate on a net basis.

Sources of interest rate risk include volatility and changes in interest rate levels, yield curves and spreads. These affect the interest rate margin realised between lending income and borrowing costs when applied to our rate sensitive assets and liabilities. The Group is also exposed to basis risk, which is the difference in repricing characteristics of two floating-rate indices such as the South African prime rate and three-month JIBAR.

To measure such risk, the Group aggregates interest rate sensitive assets and liabilities into fixed time bands in accordance with the respective interest repricing dates. The Group uses both dynamic maturity gap and duration analysis, which measures the mismatch level between the average time over which the cash inflows are generated and cash outflows are required. Various reports are prepared taking alternative strategies and interest rate forecasts into consideration. These reports are presented to the ALCO and RMC on a regular basis.

To monitor the effect of the gaps on net interest income, a regular forecast of interest rate sensitive asset and liability scenarios is produced. It includes relevant banking activity performance and trends, different forecasts of market rates and expectations reflected in the yield curve.

Risk management and control (continued)

Management of risk (continued)

Interest rate risk (continued)

For regulatory purposes, the assessment and measurement of interest rate risk is based on the accumulated impact of interest rate sensitive instruments resulting from a parallel movement of plus or minus 200 basis points on the yield curve.

In addition, the impact on equity and profit and loss resulting from a change in interest rates is calculated monthly based on management's forecast of the most likely change in interest rates.

At reporting date, a 50 basis point change was applied as a sensitivity analysis to determine exposure to interest rates. If interest rates increased/decreased by 50 basis points and all other variables remained constant, the Group's net profit and equity for the year would increase/decrease by R13.6 million (2006: increase/decrease by R11.5 million). This is mainly attributable to the Group's exposure to interest rates on its lending and borrowings in the banking book.

The table below summarises the Group's exposure to interest rate risk. Assets and liabilities are included at carrying amounts, categorised by the earlier of contractual re-pricing or maturity dates and also indicate their effective interest rates at year-end:

	Up to 1 month R'000	1 – 3 months R'000	3 – 12 months R'000	1 – 5 years R'000	Over 5 years R'000	Non- interest bearing R'000	Total R'000	Effective interest rate %
2007								
Assets								
Intangible assets	–	–	–	–	–	23 569	23 569	–
Property and equipment	–	–	–	–	–	96 969	96 969	–
Other accounts receivable	–	–	–	–	–	23 639	23 639	–
Interest in associated company	–	–	–	–	–	4 251	4 251	–
Other investments	–	–	–	–	–	228	228	–
Loans and advances	2 660 214	–	–	111 091	43 438	–	2 814 743	13.48
Derivative financial instruments	4 248	–	–	–	–	39 566	43 814	–
Negotiable securities	102 752	145 769	20 482	–	6 574	–	275 577	11.13
Cash and cash equivalents	784 050	371 528	170 618	–	–	96 798	1 422 994	9.01
Total assets	3 551 264	517 297	191 100	111 091	50 012	285 020	4 705 784	
Equity and liabilities								
Shareholders' equity	–	–	–	–	–	839 914	839 914	–
Deposits	2 122 749	590 292	802 812	146 742	348	105 240	3 768 183	7.06
Derivative financial instruments	7 875	–	–	–	–	7 481	15 356	–
Provisions	–	–	–	–	–	42 435	42 435	–
Other accounts payable	–	–	–	–	–	39 780	39 780	–
Taxation	–	–	–	–	–	116	116	–
Total equity and liabilities	2 130 624	590 292	802 812	146 742	348	1 034 966	4 705 784	
On balance sheet interest sensitivity gap	1 420 640	(72 995)	(611 712)	(35 651)	49 664	–	749 946	
Derivative financial instruments	80 950	93 209	(21 500)	(110 101)	(42 558)	–	–	
Total net interest sensitivity gap	1 501 590	20 214	(633 212)	(145 752)	7 106	–	749 946	

Risk management and control (continued)

Management of risk (continued)

Interest rate risk (continued)

	Up to 1 month R'000	1 – 3 months R'000	3 – 12 months R'000	1 – 5 years R'000	Over 5 years R'000	Non- interest bearing R'000	Total R'000	Effective interest rate %
2006								
Assets								
Intangible assets	–	–	–	–	–	11 551	11 551	–
Property and equipment	–	–	–	–	–	94 956	94 956	–
Taxation	–	–	–	–	–	29	29	–
Other accounts receivable	–	–	–	–	–	145 291	145 291	–
Interest in associated company	–	–	–	–	–	3 626	3 626	–
Other investments	–	–	–	–	–	7 209	7 209	–
Loans and advances	1 952 227	–	–	31 074	83 131	–	2 066 432	11.74
Derivative financial instruments	31 134	–	–	–	–	–	31 134	–
Negotiable securities	56 061	164 450	152 607	31 898	–	–	405 016	8.72
Cash and cash equivalents	915 131	277 851	413 317	–	–	77 675	1 683 974	8.24
Total assets	2 954 553	442 301	565 924	62 972	83 131	340 337	4 449 218	
Equity and liabilities								
Shareholders' equity	–	–	–	–	–	667 418	667 418	–
Deposits	2 209 657	640 336	617 400	13 765	–	57 989	3 539 147	6.18
Derivative financial instruments	29 189	–	–	–	–	–	29 189	–
Provisions	–	–	–	–	–	38 994	38 994	–
Other accounts payable	126 343	–	–	–	–	48 092	174 435	–
Taxation	–	–	–	–	–	35	35	–
Total equity and liabilities	2 365 189	640 336	617 400	13 765	–	812 528	4 449 218	
On balance sheet interest sensitivity gap	589 364	(198 035)	(51 476)	49 207	83 131	–	472 191	
Derivative financial instruments	94 279	89 119	(10 700)	(105 899)	(66 799)	–	–	
Total net interest sensitivity gap	683 643	(108 916)	(62 176)	(56 692)	16 332	–	472 191	

Liquidity risk

Liquidity risk is the risk of being unable to meet current and future cash flow and collateral requirements when they become due, without negatively affecting the normal course of business. The Group is exposed to daily cash needs from overnight deposits, current accounts, maturing deposits, loan drawdowns and guarantees.

To measure liquidity risk, the Group aggregates assets and liabilities into fixed time bands in accordance with the respective maturity dates, which measures the mismatch level between the average time over which the cash inflows are generated and cash outflows are required.

The ALM forum monitors liquidity risk on a daily basis and reports back to the ALCO and RMC. Ultimate responsibility for liquidity risk management rests with the Board. An appropriate liquidity risk management framework has been developed for the management of the Group's short, medium and long term funding and liquidity requirements.

Through active liquidity management, the Group seeks to preserve stable, reliable and cost effective sources of funding. To accomplish this, management uses a variety of liquidity risk measures that consider market conditions, prevailing interest rates, liquidity needs and the desired maturity profile of liabilities.

To manage this risk, the Group performs, amongst others, the following:

- maintenance of stock of readily available, high quality liquid assets in excess of the statutory requirements as well as strong balance sheet liquidity ratios;
- assumptions based sensitivity analysis to assess potential cash flows at risk;

Risk management and control (continued)

Management of risk (continued)

Liquidity risk (continued)

- management of concentration risk, being undue reliance on any single counterparty or counterparty group, sector, market, product, instrument, currency and tenor;
- maintenance of sources of funding for contingency funding needs;
- monitoring of daily cash flow movements/cash flow requirements, including daily settlements and collateral management processes;
- creation and monitoring of prudential liquidity risk limits; and
- maintenance of an appropriate term mix of funding.

There were no significant changes in the Group's liquidity position during the current financial year or the manner in which it manages and measures the risk. The Group is adequately funded and able to meet all its current and future obligations.

The table below summarises assets and liabilities of the Group into relevant maturity groupings, based on the remaining period to the contractual maturity at balance sheet date:

	Assets R'000	Liabilities R'000	Total mismatch R'000
2007			
Maturing up to one month	1 829 107	2 162 753	(333 646)
Maturing between one and three months	592 643	751 773	(159 130)
Maturing between three and six months	258 494	519 894	(261 400)
Maturing between six months and one year	179 121	284 360	(105 239)
Maturing after one year	1 846 419	147 090	1 699 329
	4 705 784	3 865 870	839 914
2006			
Maturing up to one month	1 820 121	2 346 569	(526 448)
Maturing between one and three months	484 548	804 066	(319 518)
Maturing between three and six months	419 297	401 022	18 275
Maturing between six months and one year	328 967	216 378	112 589
Maturing after one year	1 396 285	13 765	1 382 520
	4 449 218	3 781 800	667 418

Risk management and control (continued)

Management of risk (continued)

Liquidity risk (continued)

The remaining period to contractual maturity of financial liabilities of the Group as at balance sheet date which includes the interest obligation on unmatured deposits and derivatives calculated up to maturity date is summarised in the table below:

	Up to 1 month R'000	1 – 3 months R'000	3 – 6 months R'000	6 – 12 months R'000	Over 1 year R'000
2007					
Deposits	2 060 662	768 400	537 375	306 368	175 918
Derivative financial instruments	3 444	3 344	1 850	1 322	7 018
Other accounts payable	39 780	–	–	–	–
Taxation	116	–	–	–	–
Guarantees, letters of credit and committed undrawn facilities	634 861	–	–	–	–
Operating lease commitments	366	698	890	1 350	4 289
	2 739 229	772 442	540 115	309 040	187 225
2006					
Deposits	2 108 185	800 776	416 510	234 381	16 995
Derivative financial instruments	6 759	6 068	3 027	2 429	14 669
Other accounts payable	174 435	–	–	–	–
Taxation	35	–	–	–	–
Guarantees, letters of credit and committed undrawn facilities	550 542	–	–	–	–
Operating lease commitments	454	866	1 104	1 674	6 191
	2 840 410	807 710	420 641	238 484	37 855

Basel II – influencing risk management developments at Mercantile Bank Limited (“the Bank”)

The Basel Committee released the revised international Basel II Capital Accord in June 2004. The Accord is designed to differentiate minimum regulatory capital requirements in a risk sensitive manner and encourage and acknowledge sound risk management, internal control and governance practices.

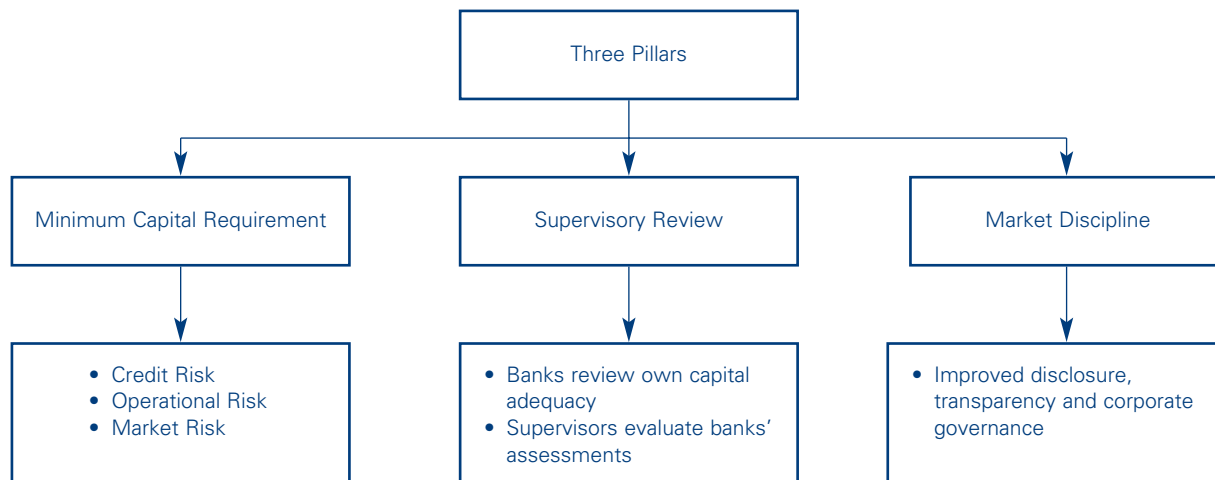
In today’s complex environment, combining effective bank-level management with market discipline and regulatory supervision, best attains systemic safety and soundness. Building on these principles, the new Accord has far reaching implications for banks in terms of minimum capital standards linked to risks, risk measurement systems and methods, risk management practices and public disclosure of risk profile information. It focuses mainly on improving the management of credit and operational risks, enhancements to the supervisory review process and more extensive risk disclosure.

The overall objective of the new Accord is to improve the safety and soundness of the financial system. This will ensure a more resilient, more stable and a better source for credit, risk intermediation and growth. The principles of Basel II were built around three pillars. These pillars can briefly be summarised by the following diagram:

Risk management and control (continued)

Management of risk (continued)

Basel II (continued)



The new Accord provides a range of approaches that vary in levels of sophistication for the measurement of credit, operational and market risk to determine capital levels. It provides a flexible structure in which banks, subject to supervisory review, will adopt approaches that best fit their level of sophistication and their risk profile. The Bank evaluated the various options available and decided that the most appropriate approaches to follow for the calculation of the minimum capital requirement in terms of the Banks Act would be the Standardised Approach for Credit, Operational and Market risk.

The Accord has been implemented with effect 1 January 2008. A pre-implementation parallel process has been in place since October 2007.

The Bank continues to form part of various Basel II committees in association with the SARB, The Banking Association and other financial institutions.

The Group recognises the significance of Basel II in aligning regulatory capital to risk and further entrenching risk reward principles and practices in bank management and decision making.

Capital management

The Group and its principal subsidiary, the Bank, are subject to minimum capital requirements as defined in the Banks Act and the Regulations relating to Banks ("the Banks Act"). The management of the Group's capital takes place under the auspices of the RMC, through the ALCO. The RMC considers the various risks faced by the Group and analyses the need to hold capital against these risks whilst taking account of the regulatory requirements. In addition, the level of capital required to support the Group's targeted business growth is taken into consideration.

Risk weighted capital is allocated to the different business units in line with their targeted growth requirements.

The objective of the Group's capital management approach is to ensure the maintenance of sound capital ratios, taking all the above requirements into account, whilst producing appropriate returns to shareholders. Capital to support the Group's needs is currently generated by retained earnings.

In terms of regulation, the Group is able to consider different tiers of capital. The capital of the Bank consists almost entirely of tier 1 capital. Following the recapitalisation of the Group in 2004, it has remained capitalised well beyond regulatory and internal requirements.

The approach to capital management has been enhanced over the past year in line with Basel II.

Risk management and control (continued)

Management of risk (continued)

Capital management (continued)

The level of capital for the Bank is as follows:

	Risk weighting	Average assets 31 December 2007 R'000	Risk-weighted assets 31 December 2007 R'000	Risk-weighted assets 31 December 2006 R'000
Banking book				
Cash, off-balance sheet activities and central government transactions	0%	1 410 022	–	–
Landbank bonds	10%	–	–	15 193
Letters of credit and other bank advances	20%	384 222	76 844	26 355
Residential mortgage loans, performance-related guarantees and committed undrawn facilities	50%	1 165 108	582 554	361 742
Other assets including counterparty risk exposure	100%	2 462 631	2 462 631	1 859 955
		5 421 983	3 122 029	2 263 245
			2007 R'000	2006 R'000
Primary capital			798 377	638 880
Share capital and share premium			1 483 299	1 483 299
General reserve			12 231	12 231
Less: Impairments			(697 153)	(856 650)
Secondary capital			39 025	43 259
General debt provisions			39 025	28 407
Fifty per cent of a revaluation surplus			–	14 852
Net qualifying capital and reserves			837 402	682 139
			2007	2006
Capital adequacy ratio (%)*			26.8	30.1
Primary capital (%)			25.6	28.2
Secondary capital (%)			1.2	1.9

* These ratios are calculated as a percentage of risk weighted assets in line with the risk weightings ascribed to these assets under the Banks Act.