



Mercantile Bank Limited

Registration number 1965/006706/06

An authorised Financial Services
and Credit Provider NCRCP19

Member of CGD Group

2011 Audited Annual Financial Statements

your bank, your partner, our focus

Mercantile Bank Limited

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In terms of section 29(1)(e)(ii) of the Companies Act, it is confirmed that the preparation of these annual financial statements is the responsibility of Mr K R Kumbier (CA)SA, Executive Director: Finance and Business.

These annual financial statements have been audited in compliance with the requirements of section 29(1)(e)(i) of the Companies Act.

Glossary of terms

Abbreviation:	Definition/Description:
AC	Audit Committee
ALCO	Asset and Liability Committee
ALM	Asset and Liability Management
Banks Act	Banks Act, No. 94 of 1990, as amended
Bank Regulations	Regulations relating to banks issued under section 90 of the Banks Act, No. 94 of 1990, as amended
CGD	Caixa Geral de Depósitos S.A., a company registered in Portugal and the ultimate holding company
Companies Act	Companies Act, No. 71 of 2008
CREDCOM	Credit Committee
MBHL	Mercantile Bank Holdings Limited, the holding company
IFRS	International Financial Reporting Standards and Interpretations
RMC	Risk and Capital Management Committee
SARB	South African Reserve Bank
the Bank	Mercantile Bank Limited
the Board	The Board of Directors
the Company	Mercantile Bank Limited

Directors' responsibility

In terms of the Companies Act, the Directors are required to maintain adequate accounting records and to prepare annual financial statements that fairly present the financial position at year-end and the results and cash flows for the year ended 31 December 2011 of the Company.

To enable the Board to discharge its responsibilities, management has developed and continues to maintain a system of internal controls. The Board has ultimate responsibility for this system of internal controls and reviews the effectiveness of its operations, primarily through the Audit Committee and other risk-monitoring committees and functions.

The internal controls include risk-based systems of accounting and administrative controls designed to provide reasonable, but not absolute, assurance that assets are safeguarded and that transactions are executed and recorded in accordance with sound business practices and the Company's written policies and procedures. These controls are implemented by trained and skilled staff with clearly defined lines of accountability and appropriate segregation of duties. The controls are monitored by management and include a budgeting and reporting system operating within strict deadlines and an appropriate control framework. As part of the system of internal controls, the Company's internal audit function conducts inspections, financial and specific audits and co-ordinates audit coverage with the external auditors.

The external auditors are responsible for reporting on the fair presentation of the Company's annual financial statements.

The Company's annual financial statements are prepared in accordance with IFRS issued by the International Accounting Standards Board, AC 500 issued by the Accounting Practices Board and incorporate responsible disclosures in line with the accounting policies of the Company. The Company's annual financial statements are based on appropriate accounting policies consistently applied, except as otherwise stated, and are supported by reasonable and prudent judgements and estimates. The Board believes that the Company will be a going concern in the year ahead. For this reason they continue to adopt the going concern basis in preparing the annual financial statements.

These annual financial statements, set out on pages 4 to 53, have been approved by the Board and are signed on their behalf by:



J A S de Andrade Campos
Chairman

27 March 2012



D J Brown
Chief Executive Officer

27 March 2012

Certificate from the Company Secretary

In terms of the provisions of the Companies Act, I certify that, to the best of my knowledge and belief, the Company has lodged with the Registrar of Companies for the financial year ended 31 December 2011 all such returns as are required of a public company in terms of the Companies Act, and that all such returns are true, correct and up to date.



A de Villiers
Company Secretary

27 March 2012

Independent auditor's report

to the shareholder of Mercantile Bank Limited

Report on the financial statements

We have audited the annual financial statements of the Company, which comprise the statement of financial position as at 31 December 2011, the statement of comprehensive income, the statement of changes in equity and the statement of cash flows for the year then ended, a summary of significant accounting policies and other explanatory information, and the Directors' report as set out on pages 6 to 53.

Directors' responsibility for the financial statements

The Directors are responsible for the preparation and fair presentation of these financial statements in accordance with IFRS and the requirements of the Companies Act of South Africa, and for such internal control as the Directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Directors, as well as evaluating the overall financial statement presentation.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at 31 December 2011, and of its financial performance and its cash flows for the year then ended in accordance with IFRS and the requirements of the Companies Act of South Africa.



Deloitte & Touche
Registered Auditors

Per Riaan Eksteen
Partner

27 March 2012

Building 8, Deloitte Place, The Woodlands, 20 Woodlands Drive, Sandton, 2196

National Executive: G G Gelink Chief Executive, A E Swiegers Chief Operating Officer, G M Pinnock Audit, D L Kennedy Risk Advisory & Legal Services, N B Kader Tax, L Geeringh Consulting, L Bam Corporate Finance, J K Mazzocco Human Resources, C R Beukman Finance, T J Brown Chairman of the Board, M J Comber Deputy Chairman of the Board

A full list of partners and directors is available on request.

BBBEE rating: Level 2 contributor in terms of the Charter Accountancy Profession Sector Code

Member of Deloitte Touche Tohmatsu Limited

Audit Committee report

for the year ended 31 December 2011

The AC is a committee of the Board and has assumed the responsibilities of an audit committee in respect of all subsidiaries of MBHL, and therefore a separate AC has not been formed for the Bank. The AC assists the Board in fulfilling its monitoring and controlling responsibilities in terms of applicable legislation.

Terms of reference

The AC is a Board committee appointed by the Board and accountable to it. Its powers and terms of reference are delegated to it by the Board and formalised in its charter which is reviewed annually and approved by the Board. The AC has executed its duties during the past financial year in accordance with its charter.

Composition

The AC comprises three independent Non-Executive Directors. At 31 December 2011 and throughout the year in review, the members were:

L Hyne (Chairman) CA(SA)
G P de Kock
T H Njikizana CA(SA)

The Chief Executive Officer, Executive Director: Finance and Business, head of Finance, representatives from the external and internal auditors and the head of Compliance attend the committee meetings by invitation. The external and internal auditors have unrestricted access to the AC Chairman or any other member of the committee as required.

Meetings

The AC held five meetings during the period under review. All members of the committee attended each of these meetings.

Statutory duties

In execution of its statutory duties during the financial year under review, the AC:

- nominated for appointment as auditor, Deloitte & Touche which, in its opinion, is independent of the Company;
- determined the fees to be paid to Deloitte & Touche as disclosed in note 22 to the annual financial statements;
- determined Deloitte & Touche's terms of engagement;
- believes the appointment of Deloitte & Touche complies with the relevant provisions of the Companies Act and King III;
- pre-approved all non-audit service contracts with Deloitte & Touche in accordance with its policy;
- received no complaints with regard to accounting practices and the internal audit of the Company, the content or auditing of its financial statements, the internal financial controls of the Company and any other related matters; and
- advised the Board that regarding matters concerning the Company's accounting policies, financial control, records and reporting, it concurs that the adoption of the going concern premise in the preparation of the financial statements is appropriate.

Internal financial control and internal audit

In the execution of its delegated duties in this area the AC has:

- reviewed and recommended the internal audit charter for approval;
- evaluated the independence, effectiveness and performance of the internal audit function;

- reviewed the effectiveness of the Company's system of internal financial controls;
- reviewed significant issues raised by the external and internal audit process and the adequacy of corrective action in response to such findings;
- obtained assurance from the external auditors that adequate accounting records were maintained; and
- reviewed policies and procedures for preventing and detecting fraud.

The head of Internal Audit functionally reported to the AC and had unrestricted access to the AC Chairman, and is of the opinion that significant internal financial controls operated effectively during the period under review.

Based on the processes and assurances obtained, the AC believes that significant internal financial controls are effective.

Regulatory compliance

The AC has complied with all applicable legal, regulatory and other responsibilities.

External audit

Based on processes followed and assurances received, the AC is satisfied that Deloitte & Touche is independent of the Bank. The AC confirmed that no reportable irregularities were identified and reported by the external auditors in terms of the Auditing Professions Act, No. 26 of 2005.

Based on our satisfaction with the results of the activities outlined above, the AC has recommended to the Board that Deloitte & Touche should be reappointed for 2012.

Finance function

The AC believes that Mr K R Kumbier, the Executive Director: Finance and Business, for the duration of 2011 up to the date of this report, possessed the appropriate expertise and experience to meet his responsibilities in that position. We are also satisfied with the expertise and adequacy of resources within the finance function.

In making these assessments, we have obtained feedback from both external and internal audit.

Based on the processes and assurances obtained, we believe that the accounting practices are effective.

Financial statements

Based on the processes and assurances obtained, we recommend the current annual financial statements be approved by the Board.

On behalf of the AC



L Hyne
Chairman of the AC

27 March 2012

Directors' report

for the year ended 31 December 2011

The Directors have pleasure in presenting their report, which forms part of the audited annual financial statements of the Company for the year ended 31 December 2011.

1. Nature of business

The Company is a registered bank, incorporated in the Republic of South Africa, and provides its clients with a full range of domestic and international banking services. In addition, it provides a full range of specialised financing, savings and investment facilities to the commercial, business, corporate and alliance banking niche markets.

2. Holding company

MBHL, a company incorporated in the Republic of South Africa, wholly owns the Company. The ultimate holding company is CGD, a company registered in Portugal.

3. Financial results

Details of the financial results are set out on pages 7 to 53 and in the opinion of the Directors require no further comment.

4. Share capital

There were no changes to the authorised and issued share capital of the Company during the year (2010: nil). The authorised and issued share capital of the Company is detailed in note 12 to the annual financial statements.

5. Dividends

A dividend of R59.929 million was declared on 31 December 2011 (2010: nil).

6. Directors, Company Secretary and registered addresses

The Directors of the Company during the year and at the date of this report were as follows:

J A S de Andrade Campos *+ (Chairman)
 D J Brown # (Chief Executive Officer)
 G P de Kock °
 L Hyne °
 A T Ikalafeng °
 K R Kumbier #
 J P M Lopes *#
 T H Njikizana ^°

* Portuguese, ^Zimbabwean,
 + Non-Executive, # Executive,
 ° Independent Non-Executive

The Company Secretary is Ms A de Villiers and the registered addresses of the Company are:

Postal:

P O Box 782699
 Sandton
 2146

Physical:

1st Floor
 Mercantile Bank
 142 West Street
 Sandown
 2196

7. Going concern

The Directors, in performing their assessment of the Company's ability to continue as a going concern, considered the approved operating budget for the next financial year as well as the cash flow forecast for the year ahead. The approved operating budget was reviewed and analysed based on the current developments in the market and operating model for the Company. The Directors believe the Company will have sufficient capital and cash resources to operate as a going concern in the year ahead.

8. Special resolutions

Four special resolutions were adopted at the AGM held on 1 June 2011 to amend the Company's Memorandum of Incorporation (previously the Articles of Association) in relation to the office of directors, directors' rotation and communication to shareholders by electronic means.

9. Events after the reporting period

No material events have occurred between the accounting date and the date of this report that require adjustment to or disclosure in the annual financial statements.

Accounting policies

for the year ended 31 December 2011

The principal accounting policies adopted in the preparation of these annual financial statements are set out below:

1. Basis of presentation

The Company's annual financial statements have been prepared in accordance with IFRS issued by the International Accounting Standards Board and AC 500 issued by the Accounting Practices Board, using the historical cost convention as modified by the revaluation of certain financial assets, liabilities and properties.

IFRSs which became effective in the current reporting period have had no impact on the Company.

2. Recognition of assets and liabilities

2.1 Assets

The Company recognises assets when it obtains control of a resource as a result of past events and from which future economic benefits are expected to flow to the Company.

2.2 Liabilities

The Company recognises liabilities when it has a present obligation as a result of past events and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

2.3 Provisions

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount of the obligation can be made.

2.4 Contingent liabilities

The Company discloses a contingent liability where it has a possible obligation as a result of past events, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Company, or it is possible that an outflow of resources will be required to settle the obligation, or the amount of the obligation cannot be measured with sufficient reliability.

3. Financial instruments

Financial assets and financial liabilities are recognised on the Company's statement of financial position when the Company has become a party to the contractual provisions of that instrument. Regular purchases or sales of financial assets are recognised using settlement date accounting. On initial recognition, financial instruments are recognised at their fair value and in the case of a financial instrument not at fair value through profit and loss; transaction costs that are directly attributable to the acquisition or issue of the financial instrument are included.

The Company derecognises a financial asset when:

- the contractual rights to the cash flows arising from the financial assets have expired or have been forfeited by the Company; or
- it transfers the financial asset including substantially all the risks and rewards of ownership of the asset; or
- it transfers the financial asset neither retaining nor transferring substantially all the risks and rewards of ownership of the asset, but no longer retaining control of the asset.

A financial liability is derecognised when and only when the liability is extinguished, that is, when the obligation specified in the contract is discharged, cancelled or has expired.

The difference between the carrying amount of a financial liability (or part thereof) extinguished or transferred to another party and consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit and loss.

3.1 Derivative financial instruments

Derivative financial assets and liabilities are classified as held-for-trading.

The Company uses the following derivative financial instruments to reduce its underlying financial risks and/or to enhance yields:

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

Derivative financial instruments ("derivatives") are not entered into for trading or speculative purposes. All derivatives are recognised on the statement of financial position. Derivative financial instruments are initially recorded at cost and are remeasured to fair value, excluding transaction costs, at each subsequent reporting date. Changes in the fair value of derivatives are recognised in profit and loss.

Derivatives in unlisted equity options, where the underlying equity instruments do not have a quoted market price in an active market and whose fair value cannot be reliably measured, and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, are measured at cost less impairment.

A derivative's notional principal reflects the value of the Company's investment in derivative financial instruments and represents the amount to which a rate or price is applied to calculate the exchange of cash flows.

3.2 Financial assets

The Company's principal financial assets are cash and cash equivalents, bank term deposits, other investments, negotiable securities, loans and advances and other accounts receivable.

Accounting policies

for the year ended 31 December 2011 (continued)

3. Financial instruments (continued)

3.2 Financial assets (continued)

Financial assets at fair value through profit and loss

Loans and receivables with fixed interest rates and corporate bonds are designated as financial assets at fair value through profit and loss. Financial assets are designated at fair value through profit and loss primarily to eliminate or significantly reduce the accounting mismatch. The Company seeks to demonstrate that by applying the fair value option, it significantly reduces measurement inconsistency that would otherwise arise from measuring derivatives at fair value with gains and losses in profit and loss, and the loans and receivables and corporate bonds at amortised cost.

Available-for-sale

Available-for-sale financial assets are those non-derivatives that are designated as available-for-sale or are not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit and loss.

Cash and cash equivalents

Cash and cash equivalents comprise cash on hand, deposits held by the Company with the SARB, domestic banks, foreign banks and Money Market funds. These financial assets have been designated as loans and receivables and are measured at amortised cost.

Bank term deposits

Bank term deposits comprise deposits held by the Company with domestic and foreign banks with a residual maturity of greater than three months. These financial assets have been designated as loans and receivables and are measured at amortised cost.

Other investments

Investments consist of unlisted and listed equity investments. Other investments, which are an integral part of the Company's structured loan portfolio, are designated at fair value through profit and loss. All other investments have been designated as available-for-sale. These assets are measured at fair value at each reporting date with the resultant gains or losses being recognised in other comprehensive income until the financial asset is sold, otherwise disposed of or found to be impaired. At that time the cumulative gains or losses previously recognised in other comprehensive income are included in profit and loss.

Negotiable securities

Negotiable securities consist of government stock, treasury bills, debentures and promissory notes.

Government stock has been designated as available-for-sale. These assets are measured at fair value at each reporting date with the resultant gains or losses being recognised in other comprehensive income until the financial asset is sold, otherwise disposed of or found to be impaired. At that time the cumulative gains or losses previously recognised in other comprehensive income are included in profit and loss.

All other negotiable securities are classified as loans and receivables and are carried at amortised cost subject to impairment.

Loans and advances

Loans and advances principally comprise amounts advanced to third parties in terms of certain products. Fixed rate loans and advances are designated at fair value through profit and loss with resultant gains and losses being included in profit and loss. Variable rate loans and advances are designated as loans and receivables and are measured at amortised cost.

Interest on non-performing loans and advances is not recognised to profit and loss, but is suspended. In certain instances, interest is also suspended where portfolio impairments are recognised.

Other accounts receivable

Other accounts receivable comprise items in transit, pre-payments and deposits, and other receivables. These assets have been designated as loans and receivables and are measured at amortised cost.

3.3 Financial liabilities

The Company's financial liabilities include deposits, tax payable and other accounts payable consisting of accruals, product-related credits and sundry creditors. All financial liabilities, other than liabilities designated at fair value through profit and loss and derivative instruments, are measured at amortised cost. For financial liabilities designated at fair value through profit and loss and derivative instruments which are measured at fair value through profit and loss, the resultant gains and losses are included in profit and loss.

3.4 Fair value estimation

The fair value of publicly traded derivatives, securities and investments is based on quoted market values at the reporting date. In the case of an asset held by the Company, the current bid price is used as a measure of fair value. In the case of a liability held, the current offer or asking price is used as a measure of fair value. Mid-market prices are used as a measure of fair value where there are matching asset and liability positions.

Accounting policies

for the year ended 31 December 2011 (continued)

3. Financial instruments (continued)

3.4 Fair value estimation (continued)

In assessing the fair value of non-traded derivatives and other financial instruments, the Company uses a variety of methods and assumptions that are based on market conditions and risks existing at each reporting date. Quoted market prices or dealer quotes for the same or similar instruments are used for the majority of securities, long-term investments and long-term debt. Other techniques, such as option pricing models, estimated discounted value of future cash flows, replacement cost, termination cost and net asset values of underlying investee entities are used to determine fair value for all remaining financial instruments.

3.5 Amortised cost

Amortised cost is determined using the effective interest rate method. The effective interest rate method is a way of calculating amortisation using the effective interest rate of a financial asset or financial liability. It is the rate that discounts the expected stream of future cash flows to maturity or the next market-based revaluation date to the current net carrying amount of the financial asset or financial liability.

3.6 Impairments

Specific impairments are made against identified financial assets. Portfolio impairments are maintained to cover potential losses which, although not specifically identified, may be present in the advances portfolio.

Advances which are deemed uncollectible are written off against the specific impairments. A direct reduction of an impaired financial asset occurs when the Company writes off an impaired account. The Company's write-off policy sets out the criteria for write-offs which involve an assessment of the likelihood of commercially viable recovery of the carrying amount of an impaired financial asset. Both the specific and portfolio impairments raised during the year less the recoveries of advances previously written off are charged to profit and loss.

The recoverable amount is the sum of the estimated future cash flows, discounted to their present value using a pre-tax discount rate that reflects the portfolio of advances' effective interest rate.

If the recoverable amount of the advance is estimated to be less than the carrying amount, the carrying amount of the advance is reduced to its recoverable amount by raising a specific impairment which is recognised as an expense.

Where the impairment loss subsequently reverses, the carrying amount of the advance is increased to the revised estimate of its recoverable amount, subject to the increased carrying amount not exceeding the carrying amount that would have been determined had no impairment loss been recognised for the advance in prior years. A reversal of an impairment loss is recognised in profit and loss immediately.

4. Foreign currency transactions

Transactions in foreign currencies are converted into the functional currency at prevailing exchange rates on the transaction date. Monetary assets, liabilities and commitments in foreign currencies are translated into the functional currency using the rates of exchange ruling at each reporting date. Gains and losses on foreign exchange are included in profit and loss.

5. Subsidiaries

Investments in subsidiaries in the Company's annual financial statements are designated as available-for-sale assets and are recognised at fair value. All gains and losses on the sale of subsidiaries are recognised in profit and loss.

6. Associated companies

Associated companies are those companies in which the Company exercises significant influence, but has no control or joint control over their financial and operating policies and holds between 20% and 50% interest therein. These investments are designated as available-for-sale assets and are recognised at fair value. This method is applied from the effective date on which the enterprise became an associated company up to the date on which it ceases to be an associated company.

The results and assets and liabilities of associated companies are incorporated in the financial statements as available-for-sale assets, except when the investment is classified as a non-current asset held for sale in which case it is accounted for in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

7. Property and equipment

7.1 Owner-occupied properties

Owner-occupied properties are held for use in the supply of services or for administrative purposes and are stated in the statement of financial position at open-market fair value on the basis of their existing use at the date of revaluation, less any subsequent accumulated depreciation calculated using the straight-line method and subsequent accumulated impairment losses. The open-market fair value is based on capitalisation rates for open-market net rentals for each property. Revaluations are performed annually by independent registered professional valuers.

Accounting policies

for the year ended 31 December 2011 (continued)

7. Property and equipment (continued)

7.1 Owner-occupied properties (continued)

Any revaluation increase, arising on the revaluation of owner-occupied properties, is credited to other comprehensive income, except to the extent that it reverses a revaluation decrease for the same asset previously recognised as an expense. The increase is credited to profit and loss to the extent that an expense was previously charged to profit and loss. A decrease in the carrying amount arising on the revaluation of owner-occupied properties is charged as an expense to the extent that it exceeds the balance, if any, held in the non-distributable reserve relating to a previous revaluation of that asset. On the subsequent sale or retirement of a revalued property, the revaluation surplus relating to that property in the non-distributable reserve is transferred to distributable reserves. The properties' residual values and useful lives are reviewed and adjusted, if appropriate, at each reporting date.

7.2 Equipment

All equipment is stated at historical cost less accumulated depreciation and subsequent accumulated impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. All other repairs and maintenance are charged to profit and loss as they are incurred.

Depreciation on equipment is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives. Leasehold improvements are depreciated over the period of the lease or over such lesser period as is considered appropriate. The equipments' residual values and useful lives are reviewed for impairment where there are indicators of impairment and adjusted, if appropriate, at each reporting date.

Assets are reviewed annually for impairment and whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of the asset's fair value, less costs to sell or its value in use.

The estimated useful lives of property and equipment are as follows:

Leasehold improvements	5–10 years
Computer equipment	3–5 years
Furniture and fittings	10 years
Office equipment	5–10 years
Motor vehicles	5 years
Owner-occupied properties	50 years
Land	Not depreciated

Gains and losses on disposal of property and equipment are determined by comparing proceeds with the carrying amount and are recognised in profit and loss. Depreciation of an asset begins when it is available for use and ceases at the earlier of the date that the asset is classified as held for sale or the date the asset is derecognised.

8. Intangible assets

Computer software

Direct costs associated with purchasing, developing and maintaining computer software programmes and the acquisition of software licenses are recognised as intangible assets if they are expected to generate future economic benefits that exceed related costs beyond one year.

Computer software and licenses that are recognised as intangible assets are amortised on the straight-line basis at rates appropriate to the expected useful lives of the assets which is usually between three and five years, but where appropriate over a maximum of 10 years and are carried at cost less any accumulated amortisation and any accumulated impairment losses. The carrying amount of capitalised computer software and licenses is reviewed annually for any indication of impairment and is written down when the carrying amount exceeds the recoverable amount.

The recoverable amount is the higher of fair value less costs to sell or its value in use. If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. An impairment loss is immediately recognised in profit and loss.

Intangible assets with indefinite useful lives and intangible assets not yet available for use are tested for impairment annually or whenever there is an indication that the asset may be impaired.

9. Non-current assets held for sale

Non-current assets are classified as held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable within 12 months, the asset is available for immediate sale in its present condition and management is committed to the sale.

Non-current assets classified as held for sale are measured at the lower of their carrying amount and fair value less costs to sell.

Accounting policies

for the year ended 31 December 2011 (continued)

10. Tax

Income tax expense represents the sum of the tax currently payable and deferred tax.

10.1 Current tax

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the statement of comprehensive income, because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are neither taxable nor deductible. The Company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

10.2 Deferred tax

Deferred tax is recognised on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit and are accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences, and deferred tax assets are generally recognised for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilised.

Such assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences associated with investments in subsidiaries and associates and interests in joint ventures, except where the Company is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax assets arising from deductible temporary differences associated with such investments and interests are only recognised to the extent that it is probable that there will be sufficient taxable profits against which to utilise the benefits of the temporary differences, and they are expected to reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset realised, based on tax rates (and tax laws) that have been enacted or substantively enacted by the reporting date. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Company expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities, and when they relate to income taxes levied by the same tax authority and the Company intends to settle its current tax assets and liabilities on a net basis.

10.3 Current and deferred tax for the period

Current and deferred tax are recognised as an expense or income in profit or loss, except when they relate to items credited or debited to other comprehensive income in which case the tax is recognised in other comprehensive income.

11. Instalment sales and leases

11.1 The Company as the lessee

The leases entered into by the Company are primarily operating leases. The total payments made under operating leases are charged to profit and loss on a straight-line basis over the period of the lease. When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

11.2 The Company as the lessor

Leases and instalment sale agreements are regarded as financing transactions with rentals and instalments receivable, less unearned finance charges being included in advances. Lease income is recognised over the term of the lease using the net investment method which reflects a constant periodic rate of return.

12. Interest income and interest expense

Except where interest is suspended, interest income and expense are recognised in profit and loss for all interest-bearing instruments measured at amortised cost using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Company estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees and basis points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Accounting policies

for the year ended 31 December 2011 (continued)

13. Fee, commission and dividend income

Fees and commissions are recognised on an accrual basis unless included in the effective interest rate. Dividend income from investments is recognised when the shareholder's right to receive payment has been established.

14. Retirement funds

The Company operates defined contribution funds, the assets of which are held in separate trustee-administered funds. The retirement funds are funded by payments from employees and by the Company. The Company contributions to the retirement funds are based on a percentage of the payroll and are charged to profit and loss as accrued.

15. Post-retirement medical benefits

The Company provides for post-retirement medical benefits to certain retired employees. These benefits are only applicable to employees who were members of the Company's medical aid scheme prior to May 2000 and who elected to retain the benefits in 2005, and are based on these employees remaining in service up to retirement age. The Company provides for the present value of the obligations in excess of the fair value of the plan assets which are intended to offset the expected costs relating to the post-retirement medical benefits. The costs of the defined benefit plan are assessed using the projected unit credit method. Under this method, the cost of providing post-retirement medical benefits is charged to profit and loss so as to spread the regular cost over the service lives of employees in accordance with the advice of qualified actuaries who value the plans annually.

Actuarial gains and losses, the effect of settlements on the liability and plan assets and the curtailment gain due to the change in the post-retirement subsidy of in-service members are recognised in profit and loss immediately.

16. Share-based payment arrangements

Equity-settled share-based payments to employees are measured at the fair value of the equity instruments at the grant date.

The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Company's estimate of equity instruments that will eventually vest, with a corresponding increase in equity. At the end of each reporting period, the Company revises its estimate of the number of equity instruments expected to vest. The impact of the revision of the original estimates, if any, is recognised in profit or loss such that the cumulative expense reflects the revised estimate, with a corresponding adjustment to the share-based payments reserve.

For cash-settled share-based payments, a liability is recognised for the goods or services acquired, measured initially at the fair value of the liability. At the end of each reporting period until the liability is settled and at the date of settlement, the fair value of the liability is remeasured with any changes in fair value recognised in profit or loss for the year.

17. Critical accounting estimates and judgements

The Company makes estimates and assumptions that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

17.1 Impairment losses on loans and advances

The Company reviews its loan portfolios to assess impairment on a monthly basis. In determining whether an impairment loss should be recorded in profit and loss, the Company makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the company.

Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows.

The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

17.2 Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets is determined by using valuation techniques. Where valuation techniques are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. The models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data. However, areas such as credit risk, volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

17.3 Impairment of available-for-sale equity investments

The Company determines that available-for-sale equity investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgement. In making this judgement, the Company evaluates, among other factors, the normal volatility in share price. In addition, impairment may be appropriate when there is evidence of deterioration in the financial health of the investee, industry and sector performance, changes in technology, operational and financing cash flows.

Accounting policies

for the year ended 31 December 2011 (continued)

17. Critical accounting estimates and judgements (continued)

17.4 Income taxes

There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Company recognises liabilities for anticipated tax issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

18. Recent accounting developments

There are new and revised standards and interpretations in issue that are not yet effective and there are no plans to early adopt. These include the following standards and interpretations that could be applicable to the business of the Company and may have an impact on future financial statements. The impact of initial application of the following standards has not been assessed as at the date of authorisation of the annual financial statements and will be applied for years ending after 31 December 2011:

	Standard	Effective date
IFRS 7	Financial Instruments: Disclosures: Amendments enhancing disclosures about transfers of financial assets	Annual periods beginning on or after 1 July 2011
IFRS 7	Financial Instruments: Amendments enhancing disclosures about offsetting of financial assets and financial liabilities	Annual periods beginning 1 January 2013 and interim periods within those periods
IFRS 7	Financial Instruments: Amendments requiring disclosures about the initial application of IFRS 9	Annual periods beginning on or after 1 January 2015 (or otherwise when IFRS 9 is first applied)
IFRS 9	Financial Instruments: Classification and measurement	Annual periods beginning on or after 1 January 2015
IFRS 10	Consolidated financial statements	Annual periods beginning on or after 1 January 2013
IFRS 11	Joint arrangements	Annual periods beginning on or after 1 January 2013
IFRS 12	Disclosure of interest in other entities	Annual periods beginning on or after 1 January 2013
IFRS 13	Fair value measurement	Annual periods beginning on or after 1 January 2013
IAS 1	Presentation of financial statements – Amendments to revise the way other comprehensive income is presented	Annual periods beginning on or after 1 July 2012
IAS 12	Income taxes: Limited scope amendment (recovery of underlying assets)	Annual periods beginning on or after 1 January 2012
IAS 19	Employee benefits – Amended standard resulting from the post-employment benefits and termination benefits projects	Annual periods beginning on or after 1 January 2013
IAS 27	Consolidated and separate financial statements – Reissued as IAS 27 Separate financial statements	Annual periods beginning on or after 1 January 2013
IAS 28	Investments in associates – Reissued as IAS 28 Investments in associated and joint ventures	Annual periods beginning on or after 1 July 2013
IAS 32	Financial instruments: Presentation – Application guidance amendments relating to the offsetting of financial assets and financial liabilities	Annual periods beginning on or after 1 January 2014

The following revised standards and interpretations which have been issued, but which are not yet effective, will have no effect on the Company:

	Standard/Interpretation	Effective date
IFRS 1	First-time Adoption of IFRS: Replacement of 'fixed dates' for certain exceptions with 'the date of transition to IFRSs'	Annual periods beginning on or after 1 July 2011
IFRS 1	First-time Adoption of IFRS: Additional exemption for entities ceasing to suffer from severe hyperinflation	Annual periods beginning on or after 1 July 2011
IFRIC 20	Stripping costs in the production phase of a surface mine	Annual periods beginning on or after 1 January 2013

Statement of financial position

at 31 December 2011

	Note	2011 R'000	2010 R'000
ASSETS			
Intangible assets	2	206 817	224 402
Property and equipment	3	20 002	27 508
Other accounts receivable	4	69 577	62 558
Interest in subsidiaries	5	204 240	94 095
Other investments	6	69 162	16 332
Deferred tax	7	16 935	57 548
Loans and advances	8	4 358 484	3 720 907
Derivative financial instruments	9	15 657	34 717
Negotiable securities	10	192 588	265 028
Cash and cash equivalents	11	936 911	1 759 897
Total assets		6 090 373	6 262 992
EQUITY AND LIABILITIES			
Shareholders' equity		1 649 695	1 566 781
Share capital and share premium	12	1 483 300	1 483 300
Share-based payments reserve		–	3 190
General reserve		12 231	12 231
Property revaluation reserve		69	69
Available-for-sale reserve		22 905	57 331
Retained earnings		131 190	10 660
Liabilities		4 440 678	4 696 211
Deposits	13	4 272 970	4 567 004
Derivative financial instruments	9	17 130	28 122
Provisions and other liabilities	14	48 703	29 920
Other accounts payable	16	101 875	71 165
Total equity and liabilities		6 090 373	6 262 992

Statement of comprehensive income

for the year ended 31 December 2011

	Note	2011 R'000	2010 R'000
Interest income	18	445 996	456 115
Interest expense	19	(181 598)	(194 644)
Net interest income		264 398	261 471
Net charge for credit losses	8.4	(10 221)	(3 422)
Net interest income after credit losses		254 177	258 049
Net gains on disposal of available-for-sale investments		–	885
Net non-interest income		283 323	170 665
Non-interest income	20	307 619	273 130
Fee and commission expenditure	21	(124 145)	(102 465)
Dividends received from subsidiary	25.2	60 000	–
Gains on remeasurement to fair value on unlisted investments	6	39 849	–
Net interest and non-interest income		537 500	429 599
Operating expenditure	22	(314 474)	(286 021)
Profit before tax		223 026	143 578
Tax	23	(42 676)	(41 362)
Profit after tax		180 350	102 216
Other comprehensive (loss)			
(Losses) on remeasurement to fair value		(36 489)	(2 363)
Release to profit and loss on disposal of available-for-sale financial assets		–	(885)
Tax relating to other comprehensive loss		2 063	529
Other comprehensive (loss) net of tax		(34 426)	(2 719)
Total comprehensive income		145 924	99 497
Profit after tax attributable to:			
Equity holder of the Company		180 350	102 216
Total comprehensive income attributable to:			
Equity holder of the Company		145 924	99 497

Statement of changes in equity

for the year ended 31 December 2011

	Share capital R'000	Share premium R'000	Share- based payments reserve R'000	General reserve R'000	Property revaluation reserve R'000	Available- for-sale reserve R'000	(Accumu- lated loss)/ Retained earnings R'000	Total R'000
Shareholders' equity at 31 December 2009	124 969	1 358 331	1 894	12 231	69	60 050	(92 310)	1 465 234
Net movement for the year	–	–	1 296	–	–	(2 719)	102 970	101 547
Total comprehensive income for the year	–	–	–	–	–	(2 719)	102 216	99 497
Profit after tax	–	–	–	–	–	–	102 216	102 216
Other comprehensive (loss)	–	–	–	–	–	(3 248)	–	(3 248)
Tax relating to other comprehensive loss	–	–	–	–	–	529	–	529
Vesting of shares in the conditional share plan	–	–	(104)	–	–	–	–	(104)
Share-based payments expense	–	–	1 400	–	–	–	754	2 154
Shareholders' equity at 31 December 2010	124 969	1 358 331	3 190	12 231	69	57 331	10 660	1 566 781
Net movement for the year	–	–	(3 190)	–	–	(34 426)	120 530	82 914
Total comprehensive income for the year	–	–	–	–	–	(34 426)	180 350	145 924
Profit after tax	–	–	–	–	–	–	180 350	180 350
Other comprehensive (loss)	–	–	–	–	–	(36 489)	–	(36 489)
Tax relating to other comprehensive loss	–	–	–	–	–	2 063	–	2 063
Dividends paid	–	–	–	–	–	–	(59 929)	(59 929)
Vesting of shares in the conditional share plan	–	–	(1 544)	–	–	–	–	(1 544)
Conversion of conditional share plan	–	–	(1 646)	–	–	–	–	(1 646)
Share-based payments expense	–	–	–	–	–	–	109	109
Shareholders' equity at 31 December 2011	124 969	1 358 331	–	12 231	69	22 905	131 190	1 649 695

Statement of cash flows

for the year ended 31 December 2011

	Note	2011 R'000	2010 R'000
Cash flows from operating activities			
Cash receipts from customers	24.1	759 723	719 869
Cash paid to customers, suppliers and employees	24.2	(569 701)	(560 467)
Cash generated from operations	24.3	190 022	159 402
Dividends received		60 364	3 474
Net (increase) in income earning assets	24.4	(573 614)	(53 431)
Net (decrease)/increase in deposits and other accounts	24.5	(270 343)	308 265
Net cash (outflow)/inflow from operating activities		(593 571)	417 710
Cash flows from investing activities			
Purchase of intangible assets	2	(8 501)	(74 896)
Purchase of property and equipment	3	(1 222)	(3 568)
Dividends paid		(59 929)	–
Proceeds on disposal of other investments		189	13 740
(Increase)/Decrease in interest in subsidiaries		(159 952)	5 974
Net cash (outflow) from investing activities		(229 415)	(58 750)
Net cash (outflow)/inflow for the year		(822 986)	358 960
Cash and cash equivalents at the beginning of the year		1 759 897	1 400 937
Cash and cash equivalents at the end of year	11	936 911	1 759 897

Notes to the annual financial statements

for the year ended 31 December 2011

1. Categories and fair values of financial instruments

1.1 Category analysis of financial instruments

	2011		2010	
	Fair value	Carrying amount	Fair value	Carrying amount
	R'000	R'000	R'000	R'000
Assets				
Available-for-sale	252 427	252 427	129 659	129 659
Other investments	29 313	29 313	16 332	16 332
Interest in subsidiaries	204 240	204 240	94 095	94 095
Negotiable securities – Government stock	18 874	18 874	19 232	19 232
Loans and receivables	5 481 399	5 482 901	5 711 639	5 712 962
Loans and advances				
Current accounts	963 370	963 370	617 914	617 914
Credit card	15 352	15 352	14 249	14 249
Mortgage loans	2 006 772	2 006 772	1 813 965	1 813 965
Instalment sales and leases	298 240	298 240	263 906	263 906
Structured loans	94 037	94 037	211 045	211 045
Other advances	924 928	924 928	723 632	723 632
Negotiable securities				
Treasury bills	172 212	173 714	214 435	215 758
Land Bank promissory notes	–	–	30 038	30 038
Cash and cash equivalents	936 911	936 911	1 759 897	1 759 897
Other accounts receivable	69 577	69 577	62 558	62 558
Designated at fair value through profit and loss	95 634	95 634	76 196	76 196
Loans and advances				
Mortgage loans	34 749	34 749	38 641	38 641
Instalment sales and leases	–	–	66	66
Other advances	21 036	21 036	37 489	37 489
Other investments	39 849	39 849	–	–
Held-for-trading				
Derivative financial instruments	15 657	15 657	34 717	34 717
	5 845 117	5 846 619	5 952 211	5 953 534
Liabilities				
Held-for-trading				
Derivative financial instruments	17 130	17 130	28 122	28 122
Amortised cost	4 374 845	4 374 845	4 638 169	4 638 169
Deposits	4 272 970	4 272 970	4 567 004	4 567 004
Other accounts payable	101 875	101 875	71 165	71 165
	4 391 975	4 391 975	4 666 291	4 666 291

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

1. Categories and fair values of financial instruments (continued)

1.2 Valuation techniques and assumptions applied for the purpose of measuring fair value

- Cash and cash equivalents have short terms to maturity. For this reason, the carrying amounts at the reporting date approximate the fair values.
- Treasury bills and Land Bank promissory notes have short terms to maturity and are carried at amortised cost. Fair value is based on quoted market values at the reporting date.
- The fair values of loans and advances that are carried at amortised cost approximate the fair values reported as they bear variable rates of interest. The fair values are adjusted for deterioration of credit quality through the application of the credit impairment models.
- Deposits generally have short terms to maturity, thus the values reported approximate the fair value.
- The fair value of publicly traded derivatives, securities and investments is based on quoted market values at the reporting date.
- The fair value of other financial assets and financial liabilities, excluding derivatives, is determined in accordance with generally accepted pricing models based on discounted cash flow analysis using prices from observable current market transactions and adjusted by relevant market pricing.
- Depending on the business and nature of the underlying investment, the fair value of other unlisted investments which are an integral part of the Bank's structured loan portfolio are valued in terms of the shareholders' agreement conditions, net asset value or an EBITDA multiple (based on the latest management accounts available). The fair value of other investments and interest in subsidiaries which are unlisted is determined by reference to the net asset value of the entity.
- The fair value of loans and advances designated at fair value through profit and loss is calculated using the credit spread observed at origination. The fair values are adjusted for deterioration of credit quality through the application of the credit impairment models.

1.3 Fair value measurements recognised in the statement of financial position

Financial instruments that are measured subsequent to initial recognition at fair value are grouped into Levels 1 to 3 based on the degree to which the fair value is observable:

- Level 1 fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

1. Categories and fair values of financial instruments (continued)

1.3 Fair value measurements recognised in the statement of financial position (continued)

	Level 1 R'000	Level 2 R'000	Level 3 R'000	Total R'000
2011				
Assets				
Available-for-sale				
Other investments*	24 923	–	4 390	29 313
Interest in subsidiaries	–	204 240	–	204 240
Negotiable securities – Government stock	18 874	–	–	18 874
Designated at fair value through profit and loss				
Loans and Advances				
Mortgage loans	–	34 749	–	34 749
Other advances	–	21 036	–	21 036
Other investments	–	–	39 849	39 849
Held-for-trading				
Derivative financial instruments	15 657	–	–	15 657
	59 454	260 025	44 239	363 718
Liabilities				
Held-for-trading				
Derivative financial instruments	17 130	–	–	17 130
	17 130	–	–	17 130
2010				
Assets				
Available-for-sale				
Other investments*	16 116	216	–	16 332
Interest in subsidiaries	–	94 095	–	94 095
Negotiable securities – Government stock	19 232	–	–	19 232
Designated at fair value through profit and loss				
Loans and Advances				
Mortgage loans	–	38 641	–	38 641
Instalment sales and leases	–	66	–	66
Other advances	–	37 489	–	37 489
Held-for-trading				
Derivative financial instruments	34 717	–	–	34 717
	70 065	170 507	–	240 572
Liabilities				
Held-for-trading				
Derivative financial instruments	28 122	–	–	28 122
	28 122	–	–	28 122

* Based on further analysis, available-for-sale other investments previously categorised as Level 2 have been transferred to Level 3 in 2011 (refer to note 1.4).

There were no transfers between Level 1 and 2 during the year.

A Level 3 investment was disposed of during 2010.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

1. Categories and fair values of financial instruments (continued)

1.4 Reconciliation of Level 3 fair value measurements of financial assets

	2011	2010
	R'000	R'000
Available-for-sale		
Other investments – unlisted equities		
Balance at the beginning of the year	–	–
Transfer from Level 2 (refer to note 1.3)	216	–
Gains on remeasurement to fair value in comprehensive income	4 174	–
Balance at the end of the year	4 390	–
Designated at fair value through profit and loss		
Other investments – unlisted equities		
Balance at the beginning of the year	–	7 682
Gains on remeasurement to fair value in comprehensive income	39 849	2 032
Realisation	–	(9 714)
Balance at the end of the year	39 849	–

2. Intangible assets

Computer software

Cost at the beginning of the year	296 926	221 803
Additions	8 501	74 896
Net transfer from property and equipment*	487	227
Write-off of obsolete software	(3 741)	–
Cost at the end of the year	302 173	296 926
Accumulated amortisation and impairment losses at the beginning of the year	(72 524)	(51 478)
Amortisation	(25 740)	(20 819)
Net transfer (from) property and equipment*	–	(227)
Write-off of obsolete software	2 908	–
Accumulated amortisation and impairment losses at the end of the year	(95 356)	(72 524)
Net carrying amount at the end of the year	206 817	224 402

* Transfer between various categories of property and equipment and intangible assets.

During 2010 and 2011 the Company identified no events or circumstances that would indicate that the Company's intangible assets may need to be impaired.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

3. Property and equipment

	Owner-occupied property R'000	Leasehold improvements R'000	Computer equipment R'000	Furniture and fittings R'000	Office equipment R'000	Motor vehicles R'000	Total R'000
2011							
Open market value/cost at the beginning of the year	164	19 570	93 980	9 902	26 191	492	150 299
Additions	–	–	279	66	877	–	1 222
Transfer*	–	–	(2 926)	10	2 429	–	(487)
Write-off of obsolete assets	–	–	(3 704)	–	–	(25)	(3 729)
Open market value/cost at the end of the year	164	19 570	87 629	9 978	29 497	467	147 305
Accumulated depreciation and impairment losses at the beginning of the year	–	(16 138)	(75 542)	(9 338)	(21 335)	(438)	(122 791)
Depreciation	–	(684)	(5 755)	(130)	(1 639)	(33)	(8 241)
Transfer*	–	–	–	(10)	10	–	–
Write-off of obsolete assets	–	–	3 704	–	–	25	3 729
Accumulated depreciation and impairment losses at the end of the year	–	(16 822)	(77 593)	(9 478)	(22 964)	(446)	(127 303)
Net carrying amount at the end of the year	164	2 748	10 036	500	6 533	21	20 002
2010							
Open market value/cost at the beginning of the year	164	19 498	91 822	9 899	25 119	492	146 994
Additions	–	72	2 416	3	1 077	–	3 568
Transfer*	–	–	(227)	–	–	–	(227)
Write-off of obsolete assets	–	–	(31)	–	(5)	–	(36)
Open market value/cost at the end of the year	164	19 570	93 980	9 902	26 191	492	150 299
Accumulated depreciation and impairment losses at the beginning of the year	–	(15 404)	(70 266)	(9 159)	(19 820)	(390)	(115 039)
Depreciation	–	(734)	(5 529)	(179)	(1 520)	(48)	(8 010)
Transfer*	–	–	227	–	–	–	227
Write-off of obsolete assets	–	–	26	–	5	–	31
Accumulated depreciation and impairment losses at the end of the year	–	(16 138)	(75 542)	(9 338)	(21 335)	(438)	(122 791)
Net carrying amount at the end of the year	164	3 432	18 438	564	4 856	54	27 508

* Transfer between various categories of property and equipment and intangible assets.

The owner-occupied property comprises stand 624 Malvern, Johannesburg, with a building thereon. The property is valued at the offer to purchase amount received.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011 R'000	2010 R'000
4. Other accounts receivable		
Items in transit	20 757	21 254
Loans to subsidiary, fellow subsidiary and holding company (refer to note 25.2)	48	13 585
Prepayments and deposits	5 106	3 839
Other receivables	43 666	23 880
	69 577	62 558
5. Interest in subsidiaries		
Unlisted		
Shares at fair value		
Portion 2 of Lot 8 Sandown (Pty) Ltd	6 933	54 493
Loans to subsidiaries	197 307	39 602
Portion 2 of Lot 8 Sandown (Pty) Ltd	87 205	34 126
LSM (Troyeville) Properties (Pty) Ltd	7 352	6 784
Custom Capital (Pty) Ltd	106 305	–
Less: Provisions held against loan accounts	(3 555)	(1 308)
	204 240	94 095
A register containing details of investments in subsidiaries is available for inspection at the registered office of the Company.		
The loans to Portion 2 of Lot 8 Sandown (Pty) Ltd and LSM (Troyeville) Properties (Pty) Ltd bear interest at the prevailing prime rate plus 2% (2010: prime rate plus 2%) and have no fixed terms of maturity.		
The loan to Custom Capital (Pty) Ltd bears interest at the prevailing repo rate and has no fixed terms of maturity.		
6. Other investments		
Available-for-sale		
Unlisted equities	4 390	216
Listed equities	24 923	16 116
Mercantile Bank Holdings Limited (shares held by the Bank for the employee share option scheme)	6 011	5 392
Visa Inc.	18 912	10 724
Designated at fair value through profit and loss		
Unlisted equities*	39 849	–
	69 162	16 332
* Certain zero cost equity options which were acquired in prior years as part of the structured loan portfolio were converted into equity in 2011 resulting in the recognition of fair value adjustments of R39.849 million (2010: nil).		
A register containing details of other investments is available for inspection at the registered office of the Company.		
7. Deferred tax		
Balance at the beginning of the year	57 548	98 381
Current year charge		
Per the statement of comprehensive income	(42 676)	(41 362)
Per the statement of changes in equity/other comprehensive income	2 063	529
	16 935	57 548
Deferred tax is attributable to the following temporary differences		
Intangible assets	(37 621)	(28 945)
Provisions and other liabilities	(10 537)	(10 689)
Calculated tax losses	44 883	82 307
Revaluations	(3 803)	(5 866)
Leases	2 120	1 784
Interest rate swaps	666	1 270
Other	21 227	17 687
	16 935	57 548
Deferred tax assets have been recognised for the carry forward amount of unused tax losses relating to the Company's operations where, inter alia, tax losses can be carried forward and there is evidence that it is probable that sufficient taxable profits will be available in the future to utilise all tax losses carried forward.		

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011 R'000	2010 R'000
8. Loans and advances		
8.1 Product analysis		
Amortised cost	4 379 212	3 712 206
Current accounts	983 266	633 290
Credit card	19 777	18 968
Mortgage loans	2 018 908	1 824 348
Instalment sales and leases	307 770	268 408
Structured loans	103 081	230 036
Other advances	946 410	737 156
Fair value through profit and loss	55 822	76 285
Mortgage loans	34 754	38 665
Instalment sales and leases	–	66
Other advances	21 068	37 554
Gross loans and advances	4 435 034	3 788 491
Less: Portfolio impairments for credit losses	(4 399)	(5 513)
Specific impairments for credit losses	(72 151)	(62 071)
	4 358 484	3 720 907

Loans and advances in foreign currencies are converted into South African rand at prevailing exchange rates at the reporting date.

8.2 Maturity analysis

Repayable on demand and maturing within one month	1 165 691	703 519
Maturing after one month but within six months	19 623	151 228
Maturing after six months but within 12 months	71 295	38 919
Maturing after 12 months	3 178 425	2 894 825
	4 435 034	3 788 491

The maturity analysis is based on the remaining period to contractual maturity at year-end.

	Gross amount R'000	Portfolio impairments R'000	Specific impairments R'000	Net balance R'000
8.3 Detailed product analysis of loans and advances				
2011				
Current accounts	983 266	1 144	18 752	963 370
Credit card	19 777	811	3 614	15 352
Mortgage loans	2 053 662	309	11 832	2 041 521
Instalment sales and leases	307 770	592	8 938	298 240
Structured loans	103 081	62	8 982	94 037
Other advances	967 478	1 481	20 033	945 964
	4 435 034	4 399	72 151	4 358 484
2010				
Current accounts	633 290	1 633	13 743	617 914
Credit card	18 968	658	4 061	14 249
Mortgage loans	1 863 013	1 145	9 262	1 852 606
Instalment sales and leases	268 474	650	3 852	263 972
Structured loans	230 036	88	18 903	211 045
Other advances	774 710	1 339	12 250	761 121
	3 788 491	5 513	62 071	3 720 907

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	Instalment						
	Total	Current	Credit	Mortgage	sales and	Structured	Other
R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000
8. Loans and advances (continued)							
8.4 Impairments for credit losses							
2011							
Balance at the beginning of the year	67 584	15 376	4 719	10 407	4 502	18 991	13 589
Movements for the year:							
Credit losses written off	(1 982)	(705)	(412)	–	(308)	–	(557)
Net impairments raised/(released)	10 948	5 225	118	1 734	5 336	(9 947)	8 482
Balance at the end of the year	76 550	19 896	4 425	12 141	9 530	9 044	21 514
2010							
Balance at the beginning of the year	64 828	5 273	4 757	3 684	3 469	18 874	28 771
Movements for the year:							
Credit losses written off	(2 542)	(4)	(694)	(230)	(442)	–	(1 172)
Net impairments raised/(released)	5 298	10 107	656	6 953	1 475	117	(14 010)
Balance at the end of the year	67 584	15 376	4 719	10 407	4 502	18 991	13 589
						2011	2010
						R'000	R'000
Net charge for credit losses in the statement of comprehensive income							
Net impairments raised						(10 948)	(5 298)
Recoveries in respect of amounts previously written off						727	1 876
						(10 221)	(3 422)

	Gross	Portfolio	Net
	amount	impairment	balance
	R'000	R'000	R'000
8.5 Product analysis of performing loans and advances			
2011			
Current accounts	946 234	1 144	945 090
Credit card	16 163	811	15 352
Mortgage loans	1 954 391	309	1 954 082
Instalment sales and leases	293 098	592	292 506
Structured loans	87 457	62	87 395
Other advances	924 863	1 481	923 382
	4 222 206	4 399	4 217 807
2010			
Current accounts	608 089	1 633	606 456
Credit card	14 884	658	14 226
Mortgage loans	1 761 523	1 145	1 760 378
Instalment sales and leases	257 594	650	256 944
Structured loans	181 207	88	181 119
Other advances	736 184	1 339	734 845
	3 559 481	5 513	3 553 968

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

2011
R'000

2010
R'000

8. Loans and advances (continued)

8.6 Product analysis of performing loans and advances excluding loans and advances with renegotiated terms

Current accounts	946 234	608 089
Credit card	16 154	14 884
Mortgage loans	1 942 801	1 749 528
Instalment sales and leases	293 098	256 885
Structured loans	87 457	181 207
Other advances	913 704	726 588
	4 199 448	3 537 181

8.7 Product analysis of loans and advances with renegotiated terms that would otherwise be past due or impaired

Current accounts	-	-
Credit card	9	-
Mortgage loans	11 590	11 995
Instalment sales and leases	-	709
Structured loans	-	-
Other advances	11 159	9 596
	22 758	22 300

	Past due for:			Total gross amount	Fair value of collateral and other credit enhancements
	1-30 days	31-60 days	61-90 days		
	R'000	R'000	R'000		

8.8 Product age analysis of loans and advances that are past due but not individually impaired

2011

Current accounts	-	-	-	-	-
Credit card	-	-	-	-	-
Mortgage loans	23 430	13 012	25 527	61 969	58 645
Instalment sales and leases	95	23	906	1 024	871
Structured loans	-	-	-	-	-
Other advances	5 707	107	9 407	15 221	6 172
	29 232	13 142	35 840	78 214	65 688

2010

Current accounts	-	-	-	-	-
Credit card	-	-	-	-	-
Mortgage loans	10 214	6 295	16 490	32 999	31 241
Instalment sales and leases	299	-	-	299	203
Structured loans	-	-	20 446	20 446	13 195
Other advances	1 536	4 346	3 562	9 444	6 032
	12 049	10 641	40 498	63 188	50 671

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	Gross amount R'000	Specific impairment R'000	Net balance R'000	Fair value of collateral and other credit enhancements R'000
8. Loans and advances (continued)				
8.9 Product analysis of loans and advances that are individually impaired				
2011				
Current accounts	37 032	18 752	18 280	9 507
Credit card	3 614	3 614	–	–
Mortgage loans	99 271	11 832	87 439	94 359
Instalment sales and leases	14 672	8 938	5 734	5 210
Structured loans	15 624	8 982	6 642	7 782
Other advances	42 615	20 033	22 582	18 730
	212 828	72 151	140 677	135 588
2010				
Current accounts	25 201	13 743	11 458	8 076
Credit card	4 084	4 061	23	–
Mortgage loans	101 490	9 262	92 228	97 716
Instalment sales and leases	10 880	3 852	7 028	7 128
Structured loans	48 829	18 903	29 926	36 233
Other advances	38 526	12 250	26 276	28 749
	229 010	62 071	166 939	177 902

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

8. Loans and advances (continued)

8.10 Collateral held as security and other credit enhancements

Fair value of collateral and other credit enhancements are determined with reference to the realisable value of security.

All customers of the Bank are accorded a client risk grading. The risk grading of a client is dependent upon the client's creditworthiness and standing with the Bank and is subjected to ongoing assessment of the client's financial standing and the acceptability of their dealings with the Bank including adherence to repayment terms and compliance with other set conditions.

Description of collateral held as security and other credit enhancements

Method of valuation

Cession of debtors	15%–75% of debtors due and payable under 90 days and depending on debtor credit quality
Pledge of shares	50% of listed shares value, nil for unlisted shares
Pledge and cession	variable depending on asset type and value
Cession of life and endowment policies	100% of surrender value
Pledge of call and savings accounts, fixed and notice deposits	100% of asset value
Vacant land	50% of professional valuation
Residential properties	75% of professional valuation
Commercial and industrial properties	70% of professional valuation
Catering, industrial and office equipment	variable depending on asset type and depreciated value
Trucks	variable depending on asset type and depreciated value
Earthmoving equipment	variable depending on asset type and depreciated value
Motor vehicles	variable depending on asset type and depreciated value
General notarial bond	variable depending on asset type and depreciated value
Special notarial bond	variable depending on asset type and depreciated value

All collateral held by the Company in respect of a loan and advance can be realised in accordance with the terms of the agreement or the facility conditions applicable thereto. Cash collateral and pledged assets that can be realised in accordance with the terms of the pledge and cession or suretyship are applied in reduction of related exposures. Pledged assets, other than cash or cash equivalent collateral, and tangible security articles are appropriated and disposed of, where necessary, after legal action, in compliance with the applicable Court rules and directives.

A customer in default will be advised of the default and afforded an opportunity to regularise the arrears. Failing normalisation of the account, legal action and repossession procedures will be followed and all attached assets disposed of in accordance with the applicable legislation. In the case of insolvent and deceased estates, the duly appointed liquidator/trustee will dispose of all assets.

8.11 Structured loans

The Company has acquired zero cost equity options attached to certain structured loans which have been recognised at cost in accordance with accounting policy 3.2.

	Notional principal of assets R'000	Fair value of assets R'000	Notional principal of liabilities R'000	Fair value of liabilities R'000
--	---	----------------------------------	--	---------------------------------------

9. Derivative financial instruments

2011

Held-for-trading

Foreign exchange contracts	979 843	15 657	784 018	14 750
Interest rate swaps	–	–	50 573	2 380
	979 843	15 657	834 591	17 130

2010

Held-for-trading

Foreign exchange contracts	1 319 956	34 658	363 419	23 525
Interest rate swaps	7 000	59	67 159	4 597
	1 326 956	34 717	430 578	28 122

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
10. Negotiable securities		
Loans and receivables		
Treasury bills	173 714	215 758
Promissory notes – Land Bank	–	30 038
Available-for-sale		
Government stock	18 874	19 232
	192 588	265 028
Maturity analysis		
Maturing within one month	74 643	49 782
Maturing after one month but within six months	99 071	191 188
Maturing after six months but within 12 months	–	4 826
Maturing after one year but within five years	18 874	19 232
	192 588	265 028

The maturity analysis is based on the remaining period to contractual maturity at year-end.

11. Cash and cash equivalents		
Cash on hand	37 338	20 504
Central Bank balances	125 632	103 248
Money Market funds	51 455	305 787
Rand denominated domestic bank balances	87 869	185 378
Foreign currency denominated bank balances*	634 617	1 144 980
	936 911	1 759 897

* Refer to note 25.2 for balances with CGD included in this amount.

	Number of issued ordinary shares	Share capital R'000	Share premium R'000	Total R'000
12. Share capital and share premium				
Opening and closing balance	62 484 353	124 969	1 358 331	1 483 300

The total authorised number of ordinary shares is 62 630 000 shares (2010: 62 630 000 shares) with a par value of R2.00 per share.

No shares were issued during the financial years ended 31 December 2010 and 31 December 2011.

The unissued shares are under the control of the shareholder until the next Annual General Meeting of MBHL.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
13. Deposits		
Call deposits and current accounts	2 181 555	2 367 784
Savings accounts	179 708	175 595
Term and notice deposits	1 750 731	1 719 410
Negotiable certificates of deposit	55 480	103 867
Foreign deposits	105 496	200 348
	4 272 970	4 567 004
Maturity analysis		
Repayable on demand and maturing within one month	2 925 176	3 054 193
Maturing after one month but within six months	891 924	817 335
Maturing after six months but within 12 months	422 541	622 906
Maturing after 12 months	33 329	72 570
	4 272 970	4 567 004

The maturity analysis is based on the remaining period to contractual maturity at year-end.

	Deferred		Post-retirement				Total
	bonus	Staff	Audit	medical	Leave	Other	
	scheme	incentives	fees	benefits	pay	risks	
	R'000	R'000	R'000	R'000	R'000	R'000	R'000
14. Provisions and other liabilities							
At 31 December 2009	–	10 189	3 700	13 863	9 522	868	38 142
Provision raised	–	–	7 520	1 286	2 087	778	11 671
Reversal of provision	–	(1 270)	–	–	–	–	(1 270)
Charged to provision	–	(8 919)	(6 610)	–	(2 168)	(926)	(18 623)
At 31 December 2010	–	–	4 610	15 149	9 441	720	29 920
Provision raised	5 793	12 000	6 450	900	167	1 109	26 419
Reversal of provision	–	–	–	–	–	(248)	(248)
Charged to provision	–	–	(7 350)	–	–	(38)	(7 388)
At 31 December 2011	5 793	12 000	3 710	16 049	9 608	1 543	48 703

Deferred bonus scheme

A cash-settled, conditional phantom share plan was approved by the Board in 2011 in place of the conditional share plan. Awards in terms of the conditional share plan that had not vested as at 30 November 2011 were converted into awards under the conditional phantom share plan (refer to note 26). This plan will be subject to similar terms and conditions as the conditional share plan, notably performance conditions and a performance period and will be governed by the Board.

Post-retirement medical benefits

Refer to note 15 for detailed disclosure of this provision.

Leave pay

In terms of Company policy, employees are entitled to accumulate leave not taken during the year within certain limits.

Other risks

Consists of provisions for legal claims and other risks. At any time, there are legal or potential claims against the Company, the outcome of which cannot at present be foreseen. Such claims are not regarded as material either on an individual basis or in aggregate. Provisions are raised for all liabilities that are expected to materialise.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

15. Post-retirement medical benefits

The Company operates a partly funded post-retirement medical scheme. The assets of the funded plans are held independently of the Company's assets in a separate trustee-administered fund. Independent actuaries value this scheme annually and the last valuation was carried out at 31 December 2011. The actuary's opinion is that the plan is in a sound financial position.

	2011	2010	2009	2008	2007
	R'000	R'000	R'000	R'000	R'000
The amounts recognised in the statement of financial position are as follows (refer to note 14):					
Present value of total service liabilities	18 577	20 648	19 370	19 664	20 223
Fair value of plan assets	(2 528)	(5 499)	(5 507)	(5 133)	(5 880)
Provident fund	(1 800)	(1 832)	(1 674)	(922)	(838)
Endowment bond	(728)	(2 530)	(2 718)	(3 118)	(3 446)
Annuities	–	(1 137)	(1 115)	(1 093)	(1 596)
Liability in the statement of financial position	16 049	15 149	13 863	14 531	14 343

The amounts recognised in the statement of comprehensive income are as follows (refer to note 22):

Current service cost	53	50	92	89	116
Interest costs	1 636	1 767	1 785	1 568	1 539
Expected return on plan assets	(509)	(578)	(526)	(529)	(549)
Discharge of liability and related plan asset	486	–	–	–	–
Actuarial gain/(loss)	767	1 488	(660)	368	936
Employer benefit payments	(1 533)	(1 441)	(1 359)	(1 308)	(1 202)
Payments from plan assets	–	–	–	–	650
Total included in staff costs	900	1 286	(668)	188	1 490

Reconciliation of the movement in the present value of total service liabilities:

At the beginning of the year	20 648	19 370	19 664	20 223	18 989
Current service cost	53	50	92	89	116
Interest costs	1 636	1 767	1 785	1 568	1 539
Discharge of liability	(1 891)	–	–	–	–
Actuarial gain/(loss)	(336)	902	(812)	(908)	781
Employer benefit payments	(1 533)	(1 441)	(1 359)	(1 308)	(1 202)
At the end of the year	18 577	20 648	19 370	19 664	20 223

Reconciliation of the movement in the fair value of plan assets:

At the beginning of the year	5 499	5 507	5 133	5 880	6 136
Expected return on plan assets	509	578	526	529	549
Non-qualifying plan asset as a result of discharge of liability	(2 377)	–	–	–	–
Actuarial (loss)/gain	(1 103)	(586)	(152)	(1 276)	(155)
Payments from plan assets	–	–	–	–	(650)
At the end of the year	2 528	5 499	5 507	5 133	5 880

The principal actuarial assumptions used were as follows:

Discount rate	8.25%	(2010: 8.25%) compounded annually
Investment return	9.25%	(2010: 9.25%) compounded annually
Rate of medical inflation	7.25%	(2010: 7.00%) compounded annually
Salary inflation	6.75%	(2010: 6.50%) compounded annually

The effect of a 1% increase/decrease on the assumed rate of medical inflation would be an increase in the liability in an amount of R1.613 million (2010: R1.973 million) and a decrease of R1.361 million (2010: R1.680 million), respectively.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
16. Other accounts payable		
Accruals	15 633	19 929
Product-related credits	73 814	31 096
Sundry creditors	12 428	20 140
	101 875	71 165
17. Contingent liabilities and commitments		
17.1 Guarantees, letters of credit and committed undrawn facilities		
Guarantees	294 263	305 669
Lending related	8 431	8 850
Mortgage	97 694	65 113
Performance	188 138	231 706
Letters of credit	24 883	10 260
Committed undrawn facilities	82 050	129 903
	401 196	445 832
17.2 Commitments under operating leases		
The total minimum future lease payments under operating leases are as follows:		
Property rentals:		
Due within one year	20 746	18 407
Due between one and five years	78 318	11 352
Due between five and ten years	21 421	–
	120 485	29 759
After tax effect on operating leases	86 749	21 426
A register containing details of the existence and terms of renewal and escalation clauses is available for inspection at the registered office of the Company.		
17.3 Capital commitments		
Contracted for consulting services for the core banking system	–	5 360
	–	5 360
18. Interest income		
Loans to subsidiaries	8 942	5 197
Loans and receivables	429 573	438 991
Cash and cash equivalents	61 480	64 515
Negotiable securities	14 287	18 791
Loans and advances	353 806	355 685
Loans and receivables designated at fair value through profit and loss		
Loans and advances	7 444	11 867
Held-for-trading		
Interest rate swaps	37	60
	445 996	456 115

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
19. Interest expense		
Deposits	176 935	190 854
Long-term funding*	1 832	–
Held-for-trading		
Interest rate swaps	2 831	3 790
	181 598	194 644
* Charges relate to arrangement and commitment fees on unutilised long-term funding at year-end.		
20. Non-interest income		
Fee and commission income		
Loans and receivables	238 294	206 820
Trading income	68 961	62 836
Held-for-trading	66 229	61 622
Foreign currency	66 237	60 261
Derivative assets	(59)	2
Derivative liabilities	51	1 359
Designated at fair value through profit and loss	2 732	1 214
Loans and advances	(79)	(818)
Other investments	2 811	2 032
Investment income		
Dividends – Other	364	3 474
	307 619	273 130
21. Fee and commission expenditure		
Foreign currency	21 984	21 452
Commissions and transactions	102 161	81 013
	124 145	102 465

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
22. Operating expenditure		
Amortisation (refer to note 2)	25 740	20 819
Auditors' remuneration		
Audit fees – Current year	6 450	7 500
Fees for other services – Tax advisory fees	170	160
– IT due diligence	62	–
– Secondment of staff	–	51
Administrative and IT staff	–	309
Less: amounts capitalised to intangible assets	–	(258)
– Other	47	23
	6 729	7 785
Depreciation (refer to note 3)	8 241	8 010
Directors' remuneration (refer to note 25.3)		
Executive Directors	12 785	7 904
Non-Executive Directors' fees	3 859	3 848
	16 644	11 752
Indirect tax		
Non-claimable Value-Added Tax	9 170	8 705
Skills development levy	1 174	1 086
	10 344	9 791
Lease charges – Equipment	41	56
Loss on sale of property and equipment	–	6
Marketing and communication	5 977	6 602
Operating leases–premises	23 609	21 838
Other operating costs	40 956	28 616
Professional fees		
Consulting	2 737	2 867
Legal and collection	1 189	252
Computer consulting and services	41 524	37 586
	45 450	40 705
Staff costs		
Salaries, wages and incentives	114 449	115 046
Post-retirement medical benefits (refer to note 15)	900	1 286
Contributions to retirement funds	8 361	8 174
Share-based payments and deferred bonus scheme expense including Directors	4 257	2 154
Other	2 776	3 381
	130 743	130 041
Total operating expenditure	314 474	286 021
Number of persons employed by the Company at year-end	404	439

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
23. Tax		
Deferred tax	42 676	41 362
Current year	39 515	39 507
Prior year	3 161	1 855
	42 676	41 362
Direct tax		
South African normal tax	–	–
South African tax rate reconciliation		
South African standard tax rate (%)	28.00	28.00
Exempt income (%)	(7.57)	(0.67)
Expenses not deductible for tax purposes (%)	0.00	0.41
Additional allowances for tax purposes (%)	(2.71)	(0.14)
Capital gain – 50% portion not taxable (%)	0.00	(0.09)
Under provision prior year (%)	1.42	1.30
Effective tax rate (%)	19.14	28.81
Estimated tax losses available for offset against future taxable income	160 296	293 953
24. Notes to statement of cash flows		
24.1 Cash receipts from customers		
Interest income	445 996	456 115
Non-interest income and net gain on disposal of available-for-sale investments	407 468	274 015
<i>Adjusted for:</i> Dividends received	(60 364)	(3 474)
Net (gain) on disposal of available-for-sale investments	–	(885)
Revaluation of fair value financial instruments	(34 104)	(7 778)
Recoveries in respect of amounts previously written off	727	1 876
	759 723	719 869
24.2 Cash paid to customers, suppliers and employees		
Interest expense	(181 598)	(194 644)
Operating expenditure and fee and commission expenditure	(438 619)	(388 486)
<i>Adjusted for:</i> Amortisation	25 740	20 819
Depreciation	8 241	8 010
Write-off of obsolete computer software	833	–
Loss on sale of property and equipment	–	6
Vesting of shares in the conditional share plan	(1 544)	(104)
Share-based payments expense	4 257	2 154
Increase/(Decrease) in provisions excluding cash-settled share-based payments provision	12 989	(8 222)
	(569 701)	(560 467)

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

	2011	2010
	R'000	R'000
24. Notes to statement of cash flows (continued)		
24.3 Reconciliation of profit before tax to cash generated from operations		
Profit before tax	223 026	143 578
Profit before tax adjusted for:		
Dividends received	(60 364)	(3 474)
Net (gain) on disposal of available-for-sale investments	–	(885)
Revaluation of fair value financial instruments	(34 104)	(7 778)
Net impairments raised	10 948	5 298
Amortisation	25 740	20 819
Depreciation	8 241	8 010
Write-off of obsolete computer software	833	–
Loss on sale of property and equipment	–	6
Vesting of shares in the conditional share plan	(1 544)	(104)
Share-based payments expense	4 257	2 154
Increase/(Decrease) in provisions excluding cash-settled share-based payments provision	12 989	(8 222)
Cash generated from operations	190 022	159 402
24.4 Net movement in income earning assets		
Decrease in negotiable securities	72 588	3 597
(Increase) in loans and advances	(646 202)	(92 304)
Decrease in bank term deposits	–	35 276
Net (increase) in income earning assets	(573 614)	(53 431)
24.5 Net movement in deposits and other accounts		
(Decrease)/Increase in deposits	(294 034)	318 270
(Increase) in other accounts receivable	(7 019)	(20 816)
Increase in other accounts payable	30 710	10 811
Net (decrease)/increase in deposits and other accounts	(270 343)	308 265

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

25. Related party information

25.1 Identity of related parties with whom transactions have occurred

The ultimate holding company (CGD), holding company (MBHL), direct and fellow subsidiaries, associated company (voluntarily liquidated in 2010) and Directors are related parties. There are no other related parties with whom transactions have taken place other than as listed below.

25.2 Related party balances and transactions

The Company, in the ordinary course of business, enters into various financial services transactions with related parties. Except for the interest-free loan from the Bank to MBHL, which was settled in December 2011, transactions are governed by commercial terms.

Balances with the holding company, direct and fellow subsidiaries:

		2011	2010
	% Held	R'000	R'000
Loans to subsidiaries			
Portion 2 of Lot 8 Sandown (Pty) Ltd	100	87 205	34 126
LSM (Troyeville) Properties (Pty) Ltd	100	7 352	6 784
Custom Capital (Pty) Ltd	74.9	158 889	–
Shareholder loan (refer to note 5)		106 305	–
Current account (included as part of loans and advances - refer to note 8)		52 584	–
Less: Provisions held against loan accounts		(3 555)	(1 308)
		249 891	39 602
Loans to the holding company and fellow subsidiary			
Mercantile Bank Holdings Limited		–	12 757
Mercantile Insurance Brokers (Pty) Ltd		48	828
		48	13 585
Deposits from holding company and fellow subsidiaries			
Mercantile Bank Holdings Limited		223	223
Mercantile Insurance Brokers (Pty) Ltd		2 111	2 794
Multi Risk Investment Holdings (Pty) Ltd		20 020	–
		22 354	3 017

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

25. Related party information (continued)

25.2 Related party balances and transactions (continued)

Transactions with the holding company, direct and fellow subsidiaries and associated company:

	2011 R'000	2010 R'000
Interest received from:		
Portion 2 of Lot 8 Sandown (Pty) Ltd	3 373	4 409
LSM (Troyeville) Properties (Pty) Ltd	761	788
Custom Capital (Pty) Ltd	4 681	–
Multi Risk Investment Holdings (Pty) Ltd	127	–
Interest paid to:		
Mercantile Insurance Brokers (Pty) Ltd	83	86
Statman Investments (Pty) Ltd*	–	707
Custom Capital (Pty) Ltd	1 608	–
Non-interest income earned from:		
Mercantile Insurance Brokers (Pty) Ltd	98	158
Custom Capital (Pty) Ltd	74	–
Dividends earned from:		
Statman Investments (Pty) Ltd*	–	3 126
Portion 2 of Lot 8 Sandown (Pty) Ltd	60 000	–
Dividends paid to:		
Mercantile Bank Holdings Limited	59 929	–
Operating expenditure with:		
Portion 2 of Lot 8 Sandown (Pty) Ltd	14 961	13 921
LSM (Troyeville) Properties (Pty) Ltd	628	1 052

* Statman Investments (Pty) Ltd was an associated company which was voluntarily liquidated in 2010.

Balances and transactions with the ultimate holding company (CGD) and its subsidiary:

CGD – Lisbon (Branch of CGD)	7 299	1 084 225
Nostro accounts*	7 869	2 530
Vostro accounts	(570)	(1 912)
Deposit accounts*	–	1 083 607
CGD – Paris (Branch of CGD)	(2 124)	225
Nostro accounts*	148	261
Vostro accounts	(2 272)	(36)
CGD – London (Branch of CGD)		
Vostro accounts	(15)	(16)
CGD	5 160	1 084 434
Banco Comercial e de Investimentos (BCI) – Mozambique (Subsidiary of CGD)	(134 801)	(107 659)
Vostro accounts	(4 543)	(3 326)
Fixed deposits	(102 800)	(103 800)
Call and notice deposits	(27 458)	(533)
Total CGD	(129 641)	976 775

* These balances are included as part of note 11, cash and cash equivalents – foreign currency denominated bank balances.

Transactions between the ultimate holding company (CGD) and the Bank:

Interest paid by CGD to the Bank	1 973	1 353
Interest paid by the Bank to BCI	7 883	2 294

Other

Post-retirement medical plan

Details of the post-retirement medical plan are disclosed in note 15.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

25. Related party information (continued)

25.3 Director and Director-related activities

No loans were made to Directors during the year under review. There were no material transactions with Directors other than the following:

	Directors' fees	Salary	Fringe benefits	Retirement funds and medical aid contributions	Performance bonus	Total
	R'000	R'000	R'000	R'000	R'000	R'000
2011						
Non-Executive Directors						
J A S de Andrade Campos	1 547	–	–	–	–	1 547
G P de Kock	635	–	–	–	–	635
L Hyne	599	–	–	–	–	599
AT Ikalafeng	507	–	–	–	–	507
T H Njikizana	571	–	–	–	–	571
Executive Directors						
D J Brown	–	3 028	–	323	2 800	6 151
K R Kumbier	–	2 342	–	252	1 400	3 994
J P M Lopes	–	1 835	312	43	450	2 640
	3 859	7 205	312	618	4 650	16 644
2010						
Non-Executive Directors						
J A S de Andrade Campos	1 413	–	–	–	–	1 413
G P de Kock	602	–	–	–	–	602
L Hyne	567	–	–	–	–	567
AT Ikalafeng	480	–	–	–	–	480
T H Njikizana	475	–	–	–	–	475
S Rapeti (resigned 29 July 2010)	311	–	–	–	–	311
Executive Directors						
D J Brown	–	2 837	–	301	–	3 138
K R Kumbier (appointed 1 June 2010)*	–	2 227	–	156	–	2 383
J P M Lopes	–	1 771	568	44	–	2 383
	3 848	6 835	568	501	–	11 752
*A sign on bonus of R0.925 million, included under 'salary', was awarded to Mr Kumbier as part of his appointment in June 2010.						
				2011	2010	
				R'000	R'000	
Share-based payments and deferred bonus scheme expense relating to Executive Directors						
D J Brown				1 213	656	
K R Kumbier (appointed 1 June 2010)				1 209	135	
Amounts paid by CGD to Executive Directors						
J P M Lopes				681	552	

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

25. Related party information (continued)

25.3 Director and Director-related activities (continued)

Service agreements

D J Brown, Chief Executive Officer

Mr Brown's employment contract as Chief Executive Officer was extended by the Board to March 2014.

In consideration for the rendering of his services under the service agreement, Mr Brown is also entitled to payment of an annual incentive bonus calculated in accordance with a performance plan as agreed with the Board from time to time.

J P M Lopes, Executive Director

Mr Lopes has been seconded to Mercantile by CGD.

Mr Lopes' employment contract was extended by the Board to July 2014. In terms of his service agreement, Mr Lopes agreed to perform such duties, functions and services as are assigned to him from time to time by the Board of Directors and which are consistent and commensurate with his position as Executive Director.

K R Kumbier, Executive Director

Mr Kumbier was employed by Mercantile as Executive Director: Finance and Business on 1 June 2010. His appointment was affirmed at the AGM held on 1 June 2011.

Share options

In terms of the share option scheme, the following share options in MBHL have been granted to D J Brown which have not yet been exercised (refer to note 26):

- on 5 October 2004, 5 000 000 at an exercise price of 18 cents each;
- on 22 March 2006, 7 000 000 at an exercise price of 40 cents each; and
- on 26 February 2007, 8 000 000 at an exercise price of 34 cents each.

Conditional share and deferred bonus scheme awards

7 600 000 conditional share awards in MBHL, with a market value on date of grant of 32 cents each, were granted to D J Brown on 22 February 2008 (refer to note 26). 1 900 000 of these awards vested and were cash settled in 2011 at a market price of 21 cents per award. The balance of awards (5 700 000) were forfeited as the performance conditions in terms of the plan were not achieved.

In terms of the conditional share plan, conditional share awards in MBHL were granted to D J Brown and K R Kumbier. During 2011 these unvested awards were converted into a deferred bonus scheme as follows:

D J Brown:

- 1 250 000 at an estimated proxy price as at 31 December 2011 of 58 cents each;
- 5 000 000 at an estimated proxy price as at 31 December 2011 of 64 cents each; and
- 7 500 000 at an estimated proxy price as at 31 December 2011 of 69 cents each.

K R Kumbier:

- 10 000 000 at an estimated proxy price as at 31 December 2011 of 64 cents each; and
- 5 000 000 at an estimated proxy price as at 31 December 2011 of 69 cents each.

Directors' interests

Except for K R Kumbier, who holds 2 016 851 (2010: 2 016 851) shares directly, no other Director held beneficial and/or non-beneficial interests, directly or indirectly, in shares issued by MBHL.

26. Share-based payments

The number of shares which could be utilised for the purposes of the share incentive schemes is 393 891 852 (2010: 393 891 852), which is 10% (2010: 10%) of the issued share capital of MBHL at year-end. At the reporting date, 32 960 000 (2010: 34 254 400) share options and nil (2010: 74 940 000) conditional share plan awards were outstanding under these schemes. The balance available to be utilised under these schemes is 296 258 685 (2010: 286 197 452). The number of scheme shares that may be issued to a single participant is 59 083 778 (2010: 59 083 778) or 1.5% (2010: 1.5%) of the total number of MBHL issued shares.

The Company recognised an expense of R4.257 million (2010: R2.154 million) relating to equity and cash-settled share-based payment transactions and the conversion of the conditional share plan to the new cash-settled conditional phantom share plan (deferred bonus scheme) – refer to notes 14 and 22.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

26. Share-based payments (continued)

Share option scheme

In terms of the Trust Deed, as amended in 2007, options can be exercised in respect of 33% of the option shares after the expiration of three years from the offer date, a further 33% after the expiration of four years from the offer date and the remaining option shares after the expiration of five years from the offer date. Prior to 2008, should the options not have been exercised by the fifth anniversary date of the offer, the option holder was obliged to exercise the option in respect of at least 20% of the options in question by the sixth anniversary date of the offer or else the said 20% of the options would lapse. The same rule applied for the seventh, eighth, ninth and tenth anniversary of the offer date until the options in question either lapsed or were exercised.

The scheme was modified in 2008 to remove the expiry condition from the sixth anniversary date and all unexpired options now lapse after 10 years from the date of issue. The scheme was replaced by the conditional share plan and no further options were granted after implementation of the conditional share plan. As at 31 December 2011 all options issued under the scheme have vested.

The Mercantile Share Incentive Trust acts as an agent on behalf of the Company in respect of this scheme.

Conditional Share Plan

The conditional share plan incentive scheme, implemented in 2008, aimed to attract, retain and reward selected employees who are able to contribute to the growth of the Company, and provide for an incentive to encourage their continued employment relationship with the Company. By providing them with the opportunity to receive shares in the Company, participants are incentivised to advance the Company's interests and to ensure that the Company attracts and retains the core competencies required for formulating and implementing the Company's business strategies. The awards, other than a guaranteed 25% of all awards, were subject to performance conditions measured over a period of three years. Due to the ongoing lack of liquidity of MBHL's shares in the market, the Board decided to discontinue new awards under the scheme for an indefinite period which may be reinstated at a future date. All existing unvested awards were converted to a new cash-settled conditional phantom share plan, explained in note 14, which is a deferred bonus scheme.

The tables below set out the movement in the options and conditional awards:

	Exercise price (cents)	Options at the beginning of the year	Forfeited/ Lapsed during the year	Exercised during the year	Options at the end of the year	Exercisable options at the end of the year	Relating to Directors*
Share option scheme							
Grant date							
2011							
20 November 2001	32	394 400	(394 400)	–	–	–	–
11 February 2002	32	160 000	–	–	160 000	160 000	–
5 October 2004	18	5 000 000	–	–	5 000 000	5 000 000	5 000 000
7 October 2004	17	250 000	–	–	250 000	250 000	–
11 February 2005	20	500 000	–	–	500 000	500 000	–
27 July 2005	32	750 000	–	–	750 000	750 000	–
9 February 2006	41	750 000	–	–	750 000	750 000	–
22 March 2006	40	9 800 000	–	–	9 800 000	9 800 000	7 000 000
26 February 2007	34	16 150 000	(400 000)	–	15 750 000	15 750 000	8 000 000
1 June 2007	36	500 000	(500 000)	–	–	–	–
		34 254 400	(1 294 400)	–	32 960 000	32 960 000	20 000 000
2010							
20 November 2001	32	394 400	–	–	394 400	394 400	–
11 February 2002	32	160 000	–	–	160 000	160 000	–
5 October 2004	18	5 000 000	–	–	5 000 000	5 000 000	5 000 000
7 October 2004	17	750 000	–	(500 000)	250 000	750 000	–
11 February 2005	20	500 000	–	–	500 000	500 000	–
27 July 2005	32	750 000	–	–	750 000	750 000	–
9 February 2006	41	750 000	–	–	750 000	750 000	–
22 March 2006	40	10 600 000	(800 000)	–	9 800 000	9 800 000	7 000 000
26 February 2007	34	17 600 000	(1 450 000)	–	16 150 000	10 659 000	8 000 000
1 June 2007	36	500 000	–	–	500 000	330 000	–
		37 004 400	(2 250 000)	(500 000)	34 254 400	29 093 400	20 000 000

* Refer to note 25.3.

Notes to the annual financial statements

for the year ended 31 December 2011 (continued)

26. Share-based payments (continued)

Conditional Share Plan

Grant date	Market price at date of grant (cents)	Conditional awards at the beginning of the year	Granted during the year	Forfeited/ Lapsed during the year	Settled during the year	Conversion of the scheme during the year	Conditional awards at the end of the year	Relating to Directors*
2011								
22 February 2008	32	21 515 000	–	(16 406 250)	(5 108 750)	–	–	–
26 March 2008	31	4 000 000	–	(3 000 000)	(1 000 000)	–	–	–
24 July 2008	26	375 000	–	(281 250)	(93 750)	–	–	–
1 November 2008	28	2 000 000	–	(1 500 000)	(500 000)	–	–	–
18 March 2009	26	14 500 000	–	(11 500 171)	(212 329)	(2 787 500)	–	–
1 July 2009	25	1 000 000	–	(819 178)	(180 822)	–	–	–
25 February 2010	20	20 050 000	–	(4 917 124)	(182 876)	(14 950 000)	–	–
1 June 2010	24	10 000 000	–	–	–	(10 000 000)	–	–
1 December 2010	20	1 500 000	–	–	–	(1 500 000)	–	–
25 March 2011	21	–	24 050 000	(200 000)	–	(23 850 000)	–	–
		74 940 000	24 050 000	(38 623 973)	(7 278 527)	(53 087 500)	–	–
2010								
22 February 2008	32	22 749 000	–	(974 522)	(259 478)	–	21 515 000	7 600 000
26 March 2008	31	4 000 000	–	–	–	–	4 000 000	–
24 July 2008	26	375 000	–	–	–	–	375 000	–
1 November 2008	28	2 200 000	–	(200 000)	–	–	2 000 000	–
18 March 2009	26	15 800 000	–	(1 214 977)	(85 023)	–	14 500 000	5 000 000
1 July 2009	25	1 000 000	–	–	–	–	1 000 000	–
25 February 2010	20	–	20 050 000	–	–	–	20 050 000	5 000 000
1 June 2010	24	–	10 000 000	–	–	–	10 000 000	10 000 000
1 December 2010	20	–	1 500 000	–	–	–	1 500 000	–
		46 124 000	31 550 000	(2 389 499)	(344 501)	–	74 940 000	27 600 000

*Refer to note 25.3.

Risk management and control

Risk management philosophy

The Bank recognises that the business of banking and financial services is conducted within an environment of complex inter-related risks that have become all too evident during the ongoing global financial crisis. The Bank 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 Bank and addresses a wide spectrum of risks that are continually evaluated and policies and procedures reviewed and stress-tested to adapt to changing circumstances. In any economy there are sectors that are more vulnerable to cyclical downturns than others. Economic variables 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. However, the Bank acknowledges the potential of concentration risk in being a niche bank and this is carefully monitored and, where appropriate, corrective action is taken. Our business development efforts are focused on the stronger companies and individuals within established policy criteria, which policy serves to eliminate weaker credit from the portfolio. The Bank remains well positioned to effectively manage identified threats in a way that minimises risks to the Bank. An independent review of risk management and controls was undertaken during 2011 identifying no material weaknesses and our risk environment was rated as mature.

A philosophy of enterprise-wide risk management within a Risk Management Monitoring and Control Framework has been implemented to ensure that all business and operational risks are managed effectively within acceptable risk profiles, policies and parameters. Risk management policies are conservative with proper regard to the mix of risk and reward. The Bank takes all necessary steps to safeguard its depositors' funds, its own asset base and shareholders' funds.

A number of risk initiatives were implemented and others further entrenched during the year. These included:

- a revamp of the Risk Control Self-Assessment process across all key areas of the Bank that involved active participation of middle management in all areas;
- the establishment of Treasury Middle Office was finalised and an audit undertaken confirming that all requisite back and front office functions had indeed been migrated;
- further enhancements to the Asset Liability Management monitoring and reporting process were implemented;
- the development of a Risk Tolerance Framework that has been approved by the Board; and
- enhancement and expansion to the prudential management schedule wherein all risk-related ratios are monitored and reported to the ALCO and Board on a monthly basis.

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 in line with changed circumstances. Risk dimensions vary in importance dependent upon the business activities of an organisation and the related risks. 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 measurement 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 Bank-wide basis involving the Board and its various committees, credit management, senior management, 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 Bank's policies and procedures manuals are subject to ongoing review and are signed off by the relevant business unit heads. These standards are an integral part of the Bank's governance structure and risk management profile, reflecting the expectations and requirements of the Board in respect of key areas of control. The standards and effective maintenance of the Risk Control Self-Assessment process ensures alignment and consistency in the way that prevalent risk types are identified, managed and form part of the four phases of the risk management life cycle, defined as:

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 determination and measurability than others, but it is necessary to ascertain the magnitude of each risk whether quantifiable or not and whether direct or indirect.

Risk management (as an independent function)

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

Risk management and control

(continued)

Risk management life cycle/process (continued)

Risk monitoring (and compliance with documented policies)

Open, two-way communication between the Bank and the 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, RMC and CREDCOM and to the SARB via the Finance Division through BA returns and periodic meetings.

Risk control (stress and back-testing)

The Bank follows a policy of ongoing stress-testing. Critical variables are sensitive to market changes both domestic and international. These are identified and modelled to determine the possible impact of any deterioration of such identified variables on the Bank's results. Both internal and external events are considered in formulating appropriate modelling criteria. A policy of back-testing for identified key variables has been approved by the Board and was implemented during the first quarter of 2011.

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 Bank 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 Bank's image and success. These decisions are usually intended to enhance the Bank'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 identified risks within the Enterprise-wide Risk Management Framework, which include:

Direct Risks

Credit Risk
Counterparty Risk
Currency Risk
Liquidity Risk
Interest Rate Risk
Market (Position) Risk
Solvency Risk
Operational Risk
Technology Risk
Compliance Risk

Indirect Risks

Strategic Risk
Reputation Risk
Legal Risk
Fraud Risk
International Risk
Political Risk
Competitive Risk
Pricing Risk

The responsibility for understanding the risks incurred by the Bank 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 Bank's strategic objectives within predefined risk management policies and tolerance levels. Major risks are managed, controlled and reviewed by an independent risk function.

The Board fully recognises that it is 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 on any significant control weaknesses identified.

A process is in place whereby the Top 10 risks faced by the Bank 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 and any changes approved by the RMC. Business and Operating Divisions are integrally involved in the process in both risk identification and evaluation.

The Bank subscribes to the 11 Principles of Sound Practices for the Effective Management and Supervision of Operational Risk as defined by the Basel Committee on Banking Supervision.

Continued focus remains on Business Continuity Management. Business Continuity Management ensures the availability of key staff and processes required to support essential activities in the event of an interruption to or disruption of business. Business Continuity Management 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.

The Capital Management Committee, under the auspices of the RMC, proactively evaluates and manages the capital requirements of the Bank as determined by Basel requirements. A comprehensive re-evaluation of the capital requirements under the Internal Capital Adequacy Assessment Process is regularly undertaken with consideration being given to all risks impacting on the need for capital reserves within the Bank. The outcome of these assessments resulted in the Bank identifying different levels of risk related to specific characteristics of the business where it was deemed prudent to hold a capital buffer in addition to the regulatory capital requirements. Such buffer requirements are re-evaluated half-yearly and adjusted where appropriate.

Under the Enterprise-wide Risk Management Framework, the direct risks of the Bank have been categorised and reported on those deemed to be of the most significance:

Risk management and control

(continued)

Credit risk

Credit parameters and tolerance levels are clearly defined and reflected in governing procedures and policies. The Bank offers a spread of banking products common to 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 Bank to credit-related losses in the event of non-performance. The counterparties to these contracts are financial institutions. The Bank continually monitors its positions and the credit ratings of its counterparties and limits the value of contracts it enters into with any one party to within pre-approved transactional limits.

At year-end, the Bank did not have any significant concentration of risk which had not been adequately provided for. There were no material exposures in advances made to foreign entities at year-end.

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

The Bank 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 new and renewal proposals for lending in excess of R2 million. In addition, an 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 Portfolio Management Department and any concerns are raised with the Credit Department and Business or Commercial banking units.

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 Bank's maximum exposure to credit risk at reporting date:

	Loans and advances R'000	Committed undrawn facilities R'000	Other R'000	Total R'000
2011				
Current accounts	983 267	–	–	983 267
Credit card	19 777	14 049	–	33 826
Mortgage loans	2 053 661	68 001	–	2 121 662
Instalment sales and leases	307 770	–	–	307 770
Structured loans	103 081	–	–	103 081
Other advances	967 478	–	–	967 478
Negotiable securities	–	–	192 588	192 588
Cash and cash equivalents	–	–	936 911	936 911
Guarantees	–	–	294 263	294 263
Letters of credit	–	–	24 883	24 883
	4 435 034	82 050	1 448 645	5 965 729
2010				
Current accounts	633 290	–	–	633 290
Credit card	18 968	14 848	–	33 816
Mortgage loans	1 863 013	115 055	–	1 978 068
Instalment sales and leases	268 474	–	–	268 474
Structured loans	230 036	–	–	230 036
Other advances	774 710	–	–	774 710
Negotiable securities	–	–	265 028	265 028
Cash and cash equivalents	–	–	1 759 897	1 759 897
Guarantees	–	–	305 669	305 669
Letters of credit	–	–	10 260	10 260
	3 788 491	129 903	2 340 854	6 259 248

Risk management and control

(continued)

Operational risk

The Bank subscribes to the 11 Principles of Sound Practices for the Effective Management and Supervision of Operational Risk.

Operational risks faced by the Bank are extensive and include risks associated with reputation, robbery, fraud, theft of data, systems access and controls, 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;
- ongoing training and upskilling of 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 critical operations environments;
- 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;
- comprehensive data security and protection;
- ongoing review of the Bank-wide Risk Control Self-Assessment Process rolled out to job functional level in high-risk operational processing areas; and
- limiting access to systems and enforcing strong password controls.

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

Technology risk

The technology risk management forms a key component of the Enterprise-wide Risk Management Framework and all components are effectively managed under the auspices of the IT Steering Committee, a Board-appointed committee. The compliance and governance aspects are independently managed within the Risk Environment and are reported on independently to the RMC.

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 Bank does not currently take proprietary trading positions and therefore has minimal exposure to market risk. Before the Bank considers entering into a proprietary trading position, the Trading Committee will evaluate and approve such positions. This committee will ensure that the Bank 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 Bank 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 prudential and regulatory limits. In the unlikely event of an unauthorised limit violation, the ALM forum records such violation which is immediately corrected and reported to the ALCO, which is a sub-committee of the RMC.

The Bank does not perform a detailed sensitivity analysis on the potential impact of a change in exchange rates on a daily basis due to the fact that the Bank does not currently have any proprietary trading positions. The impact of changes in open foreign currency client positions is modelled to take cognisance of credit risks associated with volatility in foreign currency exchange rates with the purpose of covering adverse positions through calling for initial and variation margins. A detailed sensitivity analysis is performed for liquidity and interest rate risk (described on pages 47 to 51).

There has been no significant change to the Bank's exposure to market risks or the manner in which it manages and measures the risk. Various conservative prudential risk limits are in place. Exposures under prudential risk limits and various sensitivities relating thereto are reported to the ALCO, RMC and Board on a regular basis.

Basel III proposes various changes to the management and supervision of liquidity risk. The Bank is monitoring these developments and will ensure that it is well positioned to meet the added requirements of Basel III prior to implementation by the SARB.

Foreign currency risk

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

The Bank has conservative limits in terms of net open foreign currency positions that are well below the limits allowed by the SARB. For the year under review, the highest net open position recorded for any single day was R5.45 million (2010: R4.75 million). An adverse movement in the exchange rate of 10% would reduce the Bank's income by R0.5 million (2010: R0.5 million).

Risk management and control

(continued)

Foreign currency risk (continued)

The transaction exposures and foreign exchange contracts at the reporting date are summarised as follows:

	Pound				Total R'000
	US Dollar R'000	Euro R'000	Sterling R'000	Other R'000	
2011					
Total foreign exchange assets	596 992	16 673	4 780	16 490	634 935
Total foreign exchange liabilities	(96 000)	(8 534)	(1 061)	(12)	(105 607)
Commitments to purchase foreign currency	262 255	89 071	4 790	7 893	364 009
Commitments to sell foreign currency	(763 088)	(96 877)	(9 020)	(22 700)	(891 685)
Year-end effective net open foreign currency positions	159	333	(511)	1 671	1 652
2010					
Total foreign exchange assets	1 104 488	25 697	6 856	8 145	1 145 186
Total foreign exchange liabilities	(172 412)	(19 874)	(7 910)	(337)	(200 533)
Commitments to purchase foreign currency	179 019	121 800	26 828	10 156	337 803
Commitments to sell foreign currency	(1 110 368)	(128 435)	(25 831)	(16 800)	(1 281 434)
Year-end effective net open foreign currency positions	727	(812)	(57)	1 164	1 022

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, RMC and Board.

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

The objective with the management of interest rate risk is to ensure a higher degree of interest rate margin stability and lower interest rate risk over an interest rate cycle. This is achieved by hedging material exposures and by not allowing any proprietary interest rate positions. Under interest rate swap contracts, the Bank agrees to exchange the difference between fixed and floating interest rate amounts calculated on agreed notional principal amounts. Such contracts enable the Bank 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 floating rate on the interest rate swaps is based on the three-month JIBAR and/or prime rate. The Bank 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 Bank 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 Bank aggregates interest rate-sensitive assets and liabilities into fixed time bands in accordance with the respective interest repricing dates. The Bank uses both dynamic maturity gap and duration analysis which measure 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)

Interest rate risk (continued)

The yield on assets remained under pressure during 2011 as a result of the relatively low interest rate environment in South Africa. South Africa was not immune to the global credit and liquidity crisis as well as market uncertainty in respect of the longer-term interest rate trends. Net interest income was adversely impacted by the negative endowment effect due to the current high levels of excess capital of the Bank and the high level of non-interest bearing deposits. Pressure on margins is likely to continue during 2012.

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.

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. In addition to the above, the impact of a static bank-specific favourable and unfavourable interest rate movement of 50 and 200 basis points respectively is calculated and monitored daily by the ALM forum. Various approved prudential limits are in place and monitored by the Daily ALM forum and the results are reported to the ALCO and Board regularly.

At the reporting date, a 50 basis point change in prevailing interest rates was applied as a sensitivity analysis to determine the impact on earnings as a result of a change in interest rates. If interest rates increased/decreased by 50 basis points and all other variables remained constant, the Bank's net profit and equity at year-end would increase by R8.7 million and decrease by R7.9 million (2010: increase/decrease by R10.6 million). This is mainly attributable to the Bank's exposure to interest rates on its surplus capital and lending and borrowings in the banking book.

The table below summarises the Bank's exposure to interest rate risk. Assets and liabilities are included at carrying amounts, categorised by the earlier of contractual repricing or maturity dates and also indicate their effective interest rates at year-end. The repricing profile indicates that the Bank remains asset-sensitive as interest-earning assets reprice sooner than interest-paying liabilities, before and after derivative hedging activities. Thus, future net interest income remains vulnerable to a decrease in market interest rates.

	Up to 1 month R'000	1 – 3 months R'000	4 – 12 months R'000	1 – 5 years R'000	Over five years R'000	Non- interest sensitive R'000	Total R'000	Effective interest rate %
2011								
Assets								
Intangible assets	–	–	–	–	–	206 817	206 817	–
Property and equipment	–	–	–	–	–	20 002	20 002	–
Other accounts receivable	–	–	–	–	–	69 577	69 577	–
Interest in subsidiaries	–	–	–	–	–	204 240	204 240	–
Other investments	–	–	–	–	–	69 162	69 162	–
Deferred tax assets	–	–	–	–	–	16 935	16 935	–
Loans and advances	4 401 789	–	19 320	9 639	24 540	(96 804)	4 358 484	9.16
Derivative financial instruments	–	–	–	–	–	15 657	15 657	–
Negotiable securities	74 643	99 071	–	18 874	–	–	192 588	6.03
Cash and cash equivalents	452 960	266 927	–	–	–	217 024	936 911	4.66
Total assets	4 929 392	365 998	19 320	28 513	24 540	722 610	6 090 373	
Equity and liabilities								
Total equity	–	–	–	–	–	1 649 695	1 649 695	–
Deposits	3 157 786	322 780	665 110	3 708	–	123 586	4 272 970	4.12
Derivative financial instruments	793	1 587	–	–	–	14 750	17 130	–
Provisions and other liabilities	–	–	–	–	–	48 703	48 703	–
Other accounts payable	–	–	–	–	–	101 875	101 875	–
Total equity and liabilities	3 158 579	324 367	665 110	3 708	–	1 938 609	6 090 373	
Financial position interest sensitivity gap	1 770 813	41 631	(645 790)	24 805	24 540	–	1 215 999	
Derivative financial instruments	17 594	31 529	(17 594)	(31 529)	–	–	–	
Total net interest sensitivity gap	1 788 407	73 160	(663 384)	(6 724)	24 540	–	1 215 999	

Risk management and control

(continued)

Interest rate risk (continued)

	Up to 1 month R'000	1 – 3 months R'000	4 – 12 months R'000	1 – 5 years R'000	Over five years R'000	Non- interest sensitive R'000	Total R'000	Effective interest rate %
2010								
Assets								
Intangible assets	–	–	–	–	–	224 402	224 402	–
Property and equipment	–	–	–	–	–	27 508	27 508	–
Other accounts receivable	–	–	–	–	–	62 558	62 558	–
Interest in subsidiaries	40 910	–	–	–	–	53 185	94 095	–
Other investments	–	–	–	–	–	16 332	16 332	–
Deferred tax assets	–	–	–	–	–	57 548	57 548	–
Loans and advances	3 749 310	–	–	45 499	30 786	(104 688)	3 720 907	8.62
Derivative financial instruments	59	–	–	–	–	34 658	34 717	–
Negotiable securities	49 782	63 161	132 853	19 232	–	–	265 028	6.72
Cash and cash equivalents	1 574 773	–	–	–	–	185 124	1 759 897	5.26
Total assets	5 414 834	63 161	132 853	64 731	30 786	556 627	6 262 992	
Equity and liabilities								
Shareholders' equity	–	–	–	–	–	1 566 781	1 566 781	–
Deposits	2 848 816	340 102	679 748	30 643	–	667 695	4 567 004	4.17
Derivative financial instruments	2 860	1 736	–	–	–	23 526	28 122	–
Provisions and other liabilities	–	–	–	–	–	29 920	29 920	–
Other accounts payable	–	–	–	–	–	71 165	71 165	–
Total equity and liabilities	2 851 676	341 838	679 748	30 643	–	2 359 087	6 262 992	
Financial position interest sensitivity gap	2 563 158	(278 677)	(546 895)	34 088	30 786	–	1 802 460	
Derivative financial instruments	17 630	35 604	7 000	(33 975)	(26 259)	–	–	
Total net interest sensitivity gap	2 580 788	(243 073)	(539 895)	113	4 527	–	1 802 460	

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 Bank is exposed to daily cash needs from overnight deposits, current accounts, maturing deposits, loan drawdowns and guarantees.

To measure liquidity risk, the Bank aggregates assets and liabilities into fixed time bands in accordance with the respective maturity dates which measure 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 Bank's short-, medium- and long-term funding and liquidity requirements.

Through active liquidity management, the Bank 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 Bank performs, amongst others, the following:

- the maintenance of a stock of readily available, high-quality liquid assets in excess of the statutory requirements as well as strong statement of financial position liquidity ratios;
- an assumptions-based sensitivity analysis to assess potential cash flows at risk;
- the management of concentration risk, being undue reliance on any single counterparty or counterparty group, sector, market, product, instrument, currency and tenor;
- the maintenance of sources of funding for contingency funding needs;
- the monitoring of daily cash flow movements/cash flow requirements, including daily settlements and collateral management processes;

Risk management and control

(continued)

Liquidity risk (continued)

- targeting a diversified funding base to avoid undue concentrations by investor, market source and maturity;
- the creation and monitoring of prudential liquidity risk limits; and
- the maintenance of an appropriate term mix of funding.

Overall the Bank's key liquidity risk metrics, which have been formulated to achieve a prudent liquidity profile, were maintained at acceptable levels. Through increased stress-testing, scenario analysis and contingency planning, the Bank continues to actively manage its stress funding sources and liquidity buffers to ensure that it exceeds the estimated stress funding requirements which could emanate from moderate to high-stressed liquidity events. The Bank complies with the BIS Principles for Sound Liquidity Risk Management and Supervision. Overall the Bank's liquidity position remains strong.

There were no significant changes in the Bank's liquidity position during the current financial year or the manner in which it manages and measures the risk. The Bank is adequately funded and able to meet all its current and future obligations. During 2011 the Bank entered into a seven-year term loan with the International Finance Corporation of R491 million, the full amount remains undrawn.

The remaining period to contractual maturity of financial liabilities of the Bank at the reporting 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	4 – 6 months R'000	6 – 12 months R'000	Over 1 year R'000
2011					
Deposits	2 926 067	612 370	290 107	442 203	36 954
Derivative financial instruments	6 505	4 862	2 737	1 439	1 587
Other accounts payable	150 578	–	–	–	–
Guarantees, letters of credit and committed undrawn facilities	401 196	–	–	–	–
Operating lease commitments	108 098	944	1 438	2 636	7 369
Capital commitments	–	–	–	–	–
	3 592 444	618 176	294 282	446 278	45 910
2010					
Deposits	3 054 863	574 149	253 830	658 218	80 601
Derivative financial instruments	1 316	19 985	2 077	147	4 597
Other accounts payable	71 165	–	–	–	–
Guarantees, letters of credit and committed undrawn facilities	445 832	–	–	–	–
Operating lease commitments	1 529	3 060	4 609	9 209	11 352
Capital commitments	4 106	1 254	–	–	–
	3 578 811	598 448	260 516	667 574	96 550

Risk management and control

(continued)

Liquidity risk (continued)

The table below summarises assets and liabilities of the Bank into relevant maturity groupings based on the remaining period to the contractual maturity at the reporting date:

	Assets	Liabilities	Total
	R'000	R'000	mismatch
			R'000
2011			
Maturing up to one month	1 990 716	3 082 265	(1 091 549)
Maturing between one and three months	377 537	612 864	(235 327)
Maturing between three and six months	12 682	286 658	(273 976)
Maturing between six months and one year	71 487	423 980	(352 493)
Maturing after one year	3 197 299	34 911	3 162 388
Non-contractual	440 652	–	440 652
	6 090 373	4 440 678	1 649 695
2010			
Maturing up to one month	2 579 550	3 156 594	(577 044)
Maturing between one and three months	83 572	589 407	(505 835)
Maturing between three and six months	281 223	249 990	31 233
Maturing between six months and one year	47 455	623 053	(575 598)
Maturing after one year	2 942 409	77 167	2 865 242
Non-contractual	328 783	–	328 783
	6 262 992	4 696 211	1 566 781

Basel III – influencing risk management developments at the Bank

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 implementation of Basel III is expected to have far-reaching implications for banks in terms of minimum capital standards and liquidity requirements. In addition to this, it is anticipated that the reforms will be accompanied by enhancements in supervision, risk management and governance requirements including added transparency and disclosure requirements. The Bank is monitoring developments and will ensure that it is well positioned to meet the added requirements of Basel III as approved for implementation by the SARB.

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

The Basel III package was proposed to ensure that the financial system cannot suffer the type of collapse and resultant economic slowdown that occurred between 2007 and 2009. It encompasses:

- an unweighted leverage ratio;
- two new capital buffers – a conservation buffer and a countercyclical buffer;
- new and substantial capital charges for non-cleared derivative and other financial market transactions; and
- significant revisions to the rules on the types of instrument that count as bank capital.

One of the most significant impacts of Basel III on the world's banking industry is the liquidity coverage ratio ('LCR'). This ratio is designed to promote short-term resilience of a one-month liquidity profile by ensuring that banks have sufficient high-quality liquid assets to meet potential outflows in a stressed environment. The regulations are yet to be finalised in South Africa by the SARB which recently released certain guidelines that are currently under review.

The potential impact of the LCR is already being monitored on a high level and included the preliminary results of the proposed requirements into the prudential ratios report on a monthly basis. The various ALM-related assumptions (specifically the Business as Usual assumptions) are in the process of being reviewed to include the various Basel III requirements and the beneficial impact of the IFC funding on the proposed changes.

A substantial number of changes are proposed in Basel III relating to the minimum required capital. It focuses mainly on the various qualifying forms of core tier 1 capital and further deductions against capital. Mercantile is largely unaffected by these changes due to the current high levels of tier 1 capital. The majority of current qualifying capital will still qualify as tier 1 capital when Basel III comes into effect.

Risk management and control

(continued)

Basel III – influencing risk management developments at the Bank (continued)

Key time lines for the implementation of Basel III include:

Leverage ratio parallel run:	2013
Credit value adjustment (#):	2013
Public disclosure of Leverage Ratio:	2015
Implementation of Liquidity Coverage Ratio:	2015
Implementation of Net Stable Funding Ratio:	2018
Implementation of Leverage Ratio within Pillar 1:	2018

(#) not a concern to Mercantile, but calculations still need to be performed

A substantial number of changes are proposed in Basel III relating to the minimum required capital. It focuses mainly on the various qualifying forms of core tier 1 capital and further deductions against capital.

Capital management

The Bank is subject to minimum capital requirements as defined in the Banks Act and Regulations. The management of the Bank's capital takes place under the auspices of the RMC through the ALCO. The capital management strategy is focused on maximising shareholder value over time by optimising the level and mix of capital resources whilst ensuring sufficient capital is available to support the growth objectives of the Bank. Decisions on the allocation of capital resources, conducted as part of the strategic planning and budget review, are based on a number of factors including growth objectives, return on economic and regulatory capital and the residual risk inherent to specific business lines. This is conducted as part of the Internal Capital Adequacy Assessment Process and strategic planning review on a regular basis. The RMC considers the various risks faced by the Bank and analyses the need to hold capital against these risks whilst taking account of the regulatory requirements.

Capital adequacy and the use of regulatory capital are monitored by employing techniques based on the guidelines documented in the Regulations to the Banks Act and implemented by the SARB for supervisory purposes. The SARB uses the capital adequacy ratio of banks as a key supervisory tool. In terms of regulation, the Bank 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 Bank in 2004, it has remained capitalised well beyond regulatory and internal requirements.

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

Capital to support the Bank's needs is currently generated by retained earnings and the surplus capital held.

The approach to capital management has been further enhanced over the past year in line with Basel II and will remain a focus area for the future.

Risk management and control

(continued)

Capital management (continued)

The level of capital for the Bank is as follows:

	2011 R'000	2010 R'000
Risk-weighted assets – Banking book		
Credit risk	4 371 738	4 335 032
Operational risk	801 859	808 095
Market risk	170 063	2 350
Equity	63 152	10 940
Other assets	125 315	234 963
	5 532 127	5 391 380
Net qualifying capital and reserves		
Primary capital	1 410 687	1 276 397
Share capital and share premium	1 483 300	1 483 300
Retained earnings	127 984	10 660
General reserves	12 231	12 231
Less: Deductions	(212 828)	(229 794)
Secondary capital	3 509	5 161
General allowance for credit impairment	3 475	5 127
Surplus resulting from a revaluation of specified assets	34	34
	1 414 196	1 281 558
Capital adequacy ratio (%)	25.6	23.8
Primary capital (%)	25.5	23.7
Secondary capital (%)	0.1	0.1



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