



Capital Management

*Merrill Lynch Investor Lunch
June 2005*

**Mike Brown (CFO) &
Trevor Adams (Head Group Capital
Management & Basel 2)**



Agenda



-
- New rules to the game of banking
 - Basel 2 implementation - approach
 - Basel 2 implementation - status
 - Basel 2 impacts
 - New capital management framework
 - Economic capital & risk appetite
 - Background on RAPM & cost of capital
 - Capital levels & targets
 - Integration of capital management into strategy
 - Summary & conclusion



New rules to the game of banking

New rules to the game of banking



ARISING MAINLY FROM

- Basel 2 as catalyst to risk based capital requirements
- Low inflationary environment
- Increased competition

THEREFORE, RULES ARE CHANGING REQUIRING:

- Optimising risk profile of balance sheet
- Optimising capital levels
- Integrating risk, capital & strategy
- Value based management

Balance sheet optimisation

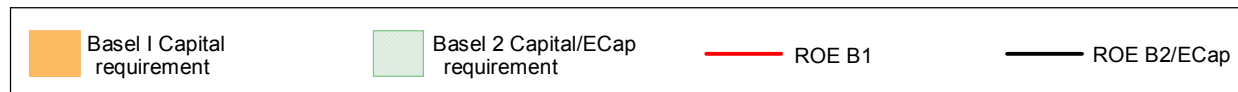
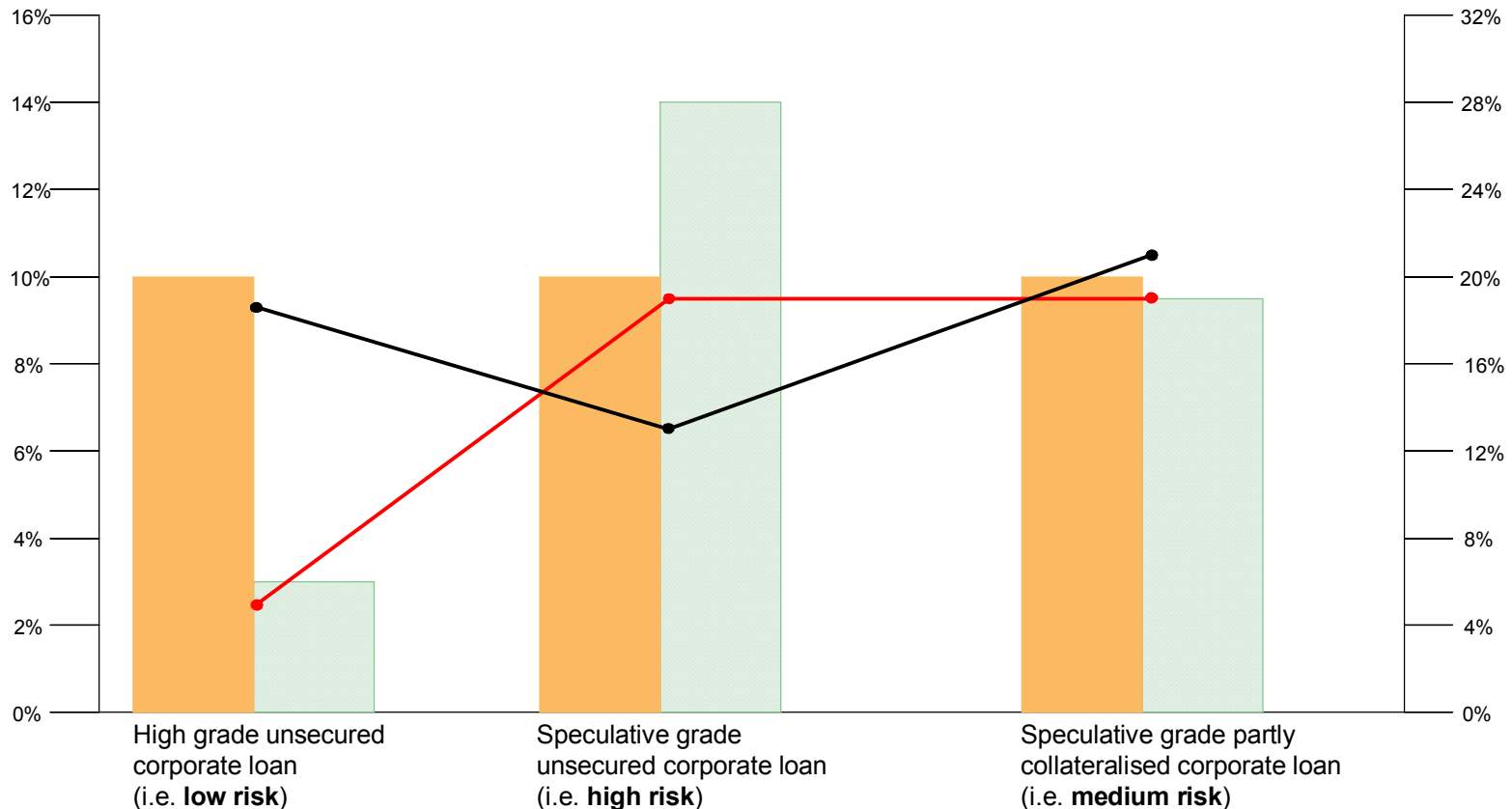


Illustrative

Balance sheet profitability impact analysis (Basel 2 / Economic Capital vs. Basel 1)

Capital%

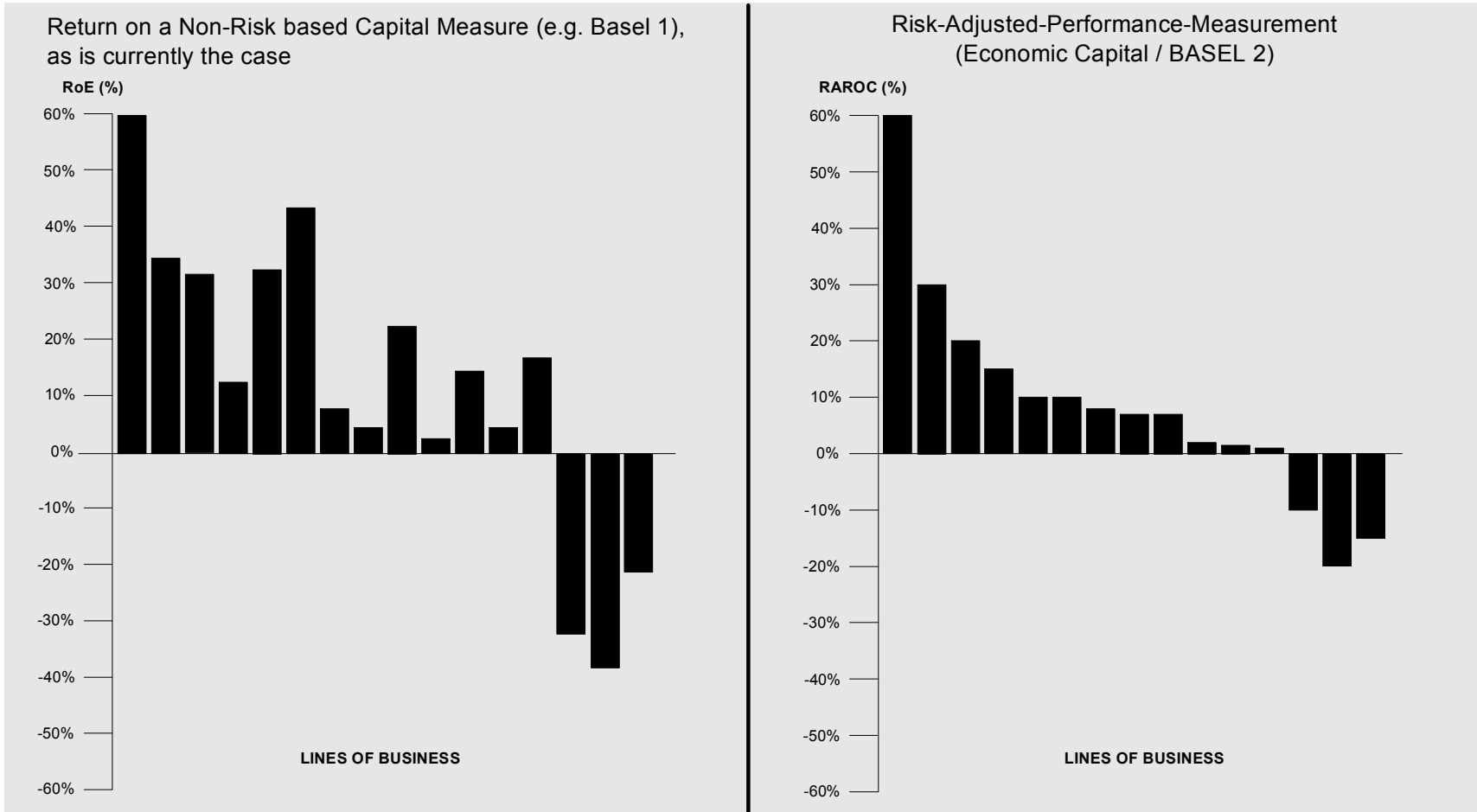
ROE%



Risk adjusted vs non-adjusted measures



ILLUSTRATIVE



■ Preliminary results at Nedbank Group have confirmed this experience

... better highlight value creation / destruction





Basel 2 implementation - approach

Strategic approach to Basel 2



2003 - 2004

PLANNING

- Central Basel 2 Programme office
 - Expert advisors
 - Gap analysis
- 
- Master implementation plan
- 
- Detailed scope of work

2003 - 2005

RISK & CAPITAL MEASUREMENT

- Credit rating tools & scoring models
 - Risk profiling tools
 - Credit Portfolio Model
 - Market Risk
 - Operational Risk
 - IT systems
- 
- Economic & Basel 2 capital

2004 - 2006

RISK & CAPITAL MANAGEMENT

- Capital mngt
- Credit pfolio mngt
- Credit process redesign
- Risk-based pricing
- ALM
- Risk & Capital MIS
- Enterprise-wide risk mngt
- Operational risk mngt

2005 - 2007

VALUE BASED MANAGEMENT

- Capital optimisation
- Client value mngt
- Managing portfolio distributions
- Integrated strategic planning
- Credit process implementation
- RAPM (based on ECap, FTP & AJTP)

Data mngt, IT automation, education / training & change mngt



Balance sheet risk / return



BALANCE SHEET LEVEL

EXAMPLES OF INITIATIVES

Portfolio

- Group credit portfolio model
 - Determine risk 'hot spots'
 - Diversification benefits into lending decisions
-

Business Unit level

- Economic capital allocation
 - Risk adjusted performance measurement
 - Review growth on risk-adjusted basis
-

Segment level (asset class)

- Build risk rating models & profiling tools
 - Cluster financial risk labs
-

Transaction / client level

- Integrate risk into pricing & client profitability evaluation
- Identify high risk, value destroying clients

Targeted Basel 2 approaches



- Advanced IRB approach for credit risk
- Standardised approach / Alternative Standardised approach for operational risk
 - Work streams underway for Advanced Measurement approach
- Internal Model approach for market risk
- High standards for ALM (in respect of Pillar 2)
- Comprehensive Capital Management (in respect of Pillar 2)

... day one implementation 1 January 2008

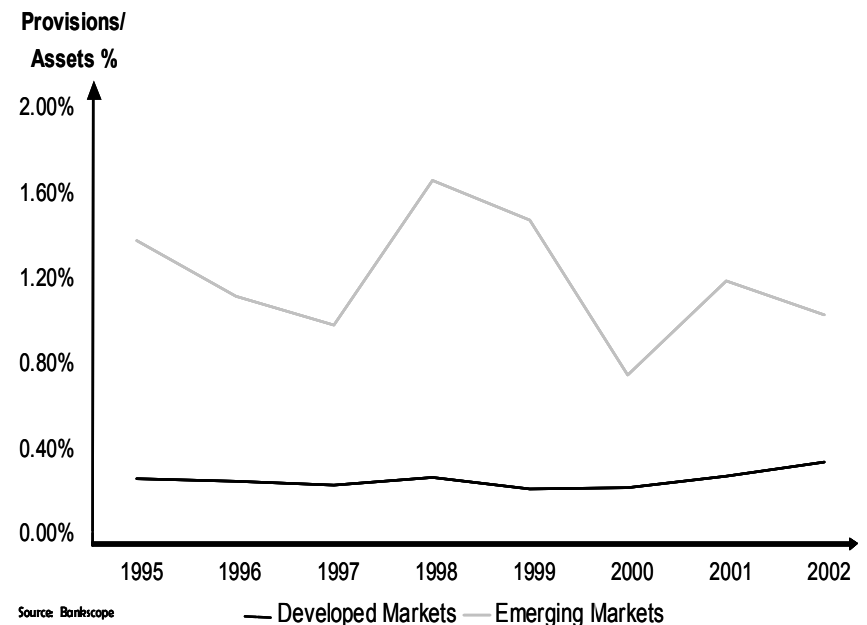
Risk measurement methodologies



Risk Characteristics of Emerging Markets:

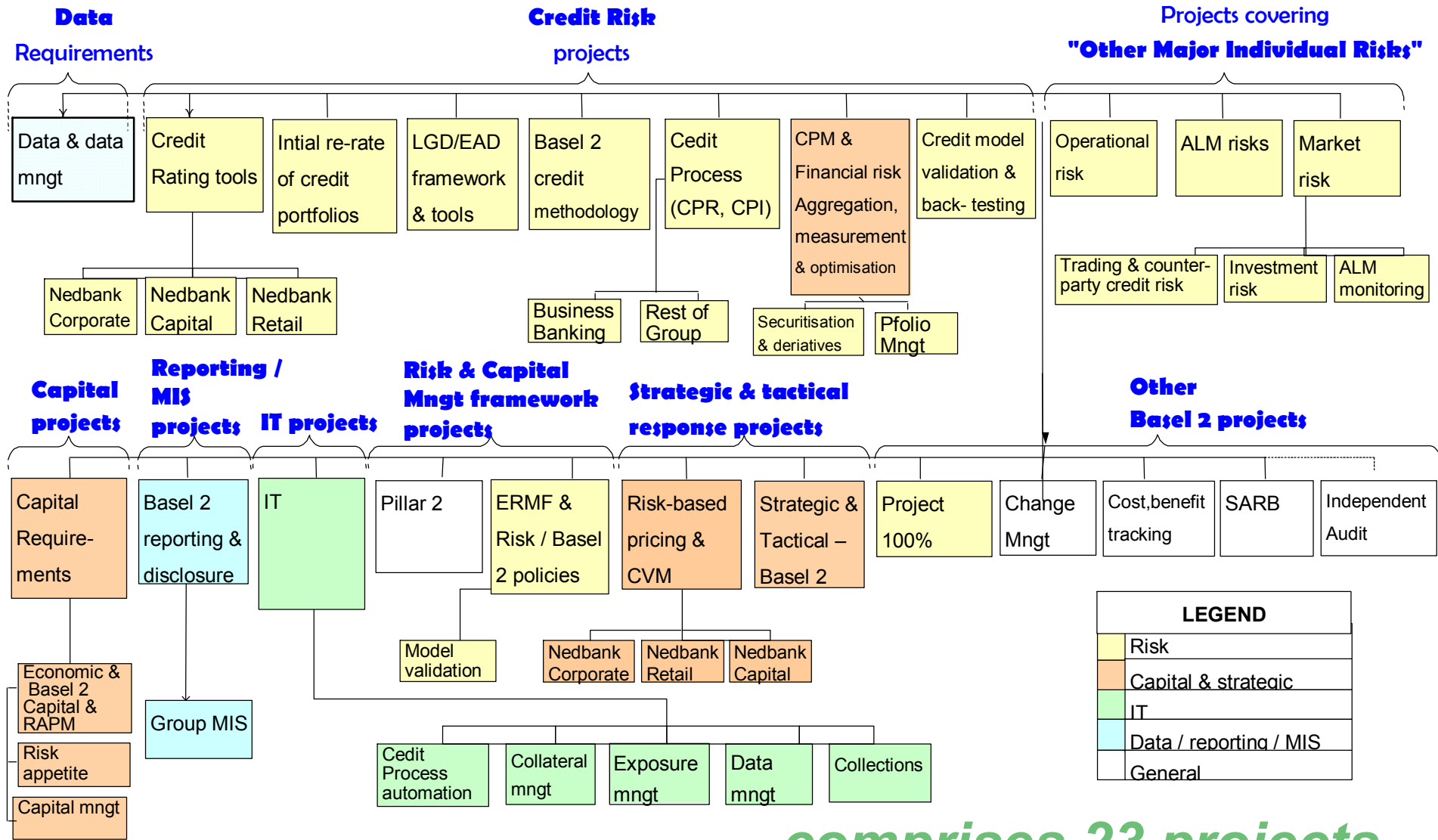
- Higher default rates
- Higher volatility in market variables
- Higher correlation between industries
- Lower levels of liquidity in credit and other financial markets
- Higher levels of collateral taken in corporate cluster lending
- More aggressive LTVs in retail lending (including some >100% LTV lending)

Comparison of Aggregate Provisions – Developed and Emerging Markets:



... must be tailored for emerging markets

Nedbank's Basel 2 programme



... comprises 23 projects



Basel 2 implementation - status

Key Basel 2 deliverables



DELIVERED AS AT 30 JUNE 2005

Data & Data Management

- Significant data collection effort
- Data systems gap analysis (SAS/IBM used)

Credit Rating Tools

- 8 of 9 new credit rating (PD) models for corporate exposures built and in use
- 35 Retail PD, LGD and EAD models built and in use
- Business Cluster Financial Risk Labs established and resourced

Initial Re-rate of Credit Portfolios

- > 80% of credit portfolios re-rated using new PD rating models (credit risk accounts for \pm 80% of risk capital requirements).

LGD / EAD framework & Tools

- LGD/EAD tools and framework for corporate exposures built and in use (needed for AIRB approach)

Key Basel 2 deliverables (*continued*)



DELIVERED AS AT 30 JUNE 2005

Group Basel 2 Credit Methodology

- New Group Credit methodology aligned with AIRB (Basel 2), completed
- New Nedbank Group Master Rating Scale developed & in use
- New methodology already in partial use (phase – in approach)

Credit Process Redesign (CPR) & Implementation (CPI)

- Completed major (7 month) CPR project in Business Banking
- Strong focus on credit process enhancement, Basel 2's "Use Test" & full implementation / integration of new credit tools

Credit Portfolio Model (CPM) & Financial Risk Aggregation

- Group Credit Portfolio Model (CPM) built & in use
- Established new Group CPM unit (part of new Group Capital Management Division)

Credit Model Validation & Back-testing

- Independent Group Credit Ratings, Methodology and Validation Unit set up
- Back testing processes formalised for new models
- Credit Model Validation Framework developed (Version 1)

Key Basel 2 deliverables (*continued*)



DELIVERED AS AT 30 JUNE 2005

Operational Risk

- Standardised Approach requirements in Basel 2 completed
- AMA planning underway (PWC consulting)
- Data collection process in place

ALM Risk (incl. FTP)

- Significantly improved ALCO process
- Strong ALM management in place (Group ALM division reports to CFO)
- FTP implemented

Market Risk

- Internal model (VaR) for Trading Risk (SARB approval pending)
- Investment Risk universe defined & measurement (version 1) completed

Capital Requirements

- Refer later slides

Key Basel 2 deliverables (*continued*)



DELIVERED AS AT 30 JUNE 2005

Basel 2 Reporting & Disclosure Requirements

- Scoping done (includes all risk & capital MIS requirements)
- Integrated with Group's Financial Processing Architecture project

Information Technology

- Credit process automation (25% complete)
- Exposure Management System (RICOS) delivered
- Data systems gap closure-plan
- Data systems / data warehousing requirements (50% complete)
- Basel 2 IT Architecture-plan

Pillar 2

- Pillar 2 requirements substantially covered by:
 - Project 7 (CPM) – concentration risk
 - Project 8 (validation & stress testing)
 - Project 10 (ALM risk) – interest rate & liquidity risks
 - Project 12 (Capital Requirements) – Capital Management
 - Project 16 (ERMF) – Governance & Policies

Key Basel 2 deliverables (*continued*)



DELIVERED AS AT 30 JUNE 2005

ERMF & group level risk / Basel 2 policies

- ERMF designed & approved in 2003
- ERMF updated & fully implemented / rolled-out in 2004, including comprehensive group-level risk policies

Risk Based Pricing (RBP) & Customer Value Mngt (CVM)

- RBP / CVM projects underway in all 3 business clusters

Strategic & tactical response to Basel 2

- Basel 2 / Economic Capital impact assessments done & ongoing
- Quick wins identified, initial planning done & mngt action underway
- Fully fledged Risk Based Strategic Planning on track (Q3 2005)

Project 100% (all other Nedbank Group subsidiaries)

- Planning done
- Work commenced at Imperial Bank & Nedbank Namibia
- New CEO, CFO & CRO appointed at Imperial Bank

Key Basel 2 deliverables (*continued*)



DELIVERED AS AT 30 JUNE 2005

Change Management

- Extension education / knowledge transfer programme underway (since 2004) at all levels (incl. Non-Executive directors)
- Communication & documentation well advanced

Costs, benefits & capabilities tracking

- Cost / Benefits analysis ongoing

SARB Basel 2 requirements & liaison

- SARB Basel 2 Gap Analysis
- Quantitative Impact Study (QIS) 4
- Planning (comprehensive Scope of Work document, signed by all relevant senior management and the Board of Directors).

Independent Audit Assurance

- Quality Assurance Review plan done

Key Basel 2 deliverables (*continued*)



REMAINING KEY DELIVERABLES

Data & Data Management

- Data Governance Framework (by 15/12/05)

Credit process Redesign (CPR) & Implementation (CPI)

- Complete CPR for rest of Bank (by 30/09/05)
- Complete CPI (by 31/03/06)

Credit Portfolio Model (CPM) & Financial Risk Aggregation

- Group Portfolio Management beyond Credit Risk (by 30/06/06)
- Cluster credit portfolio management (by 31/03/06)

Credit Model Validation and Back-testing

- Final Credit Model Validation Framework (by 31/03/06)
- Fully effective (30/06/06)

ALM Risks (incl. FTP)

- ALM measurement capabilities / modelling to world class standards (by 31/12/05)

Key Basel 2 deliverables (*continued*)



REMAINING KEY DELIVERABLES

Market Risk

- Final Investment Risk methodology (by 30/09/05)
- Investment Risk methodology implemented (by 30/06/06)

Capital Requirements

- See later slides

Information Technology

- Credit Process Automation (100%) (by 31/12/05)
- Collateral Management System (by 30/09/05)
- Data Management System (interim by 30/09/05; final by 30/09/07)
- Collection Management System (by 30/06/06)
- Basel 2 IT Architecture and workflows (by 30/06/06)

Pillar 2

- Complete outstanding pillar 2 work (by 31/03/06)

Key Basel 2 deliverables (*continued*)



REMAINING KEY DELIVERABLES

ERMF and Group level Risk / Basel 2 Policies

- Formalise Basel 2 into Nedbank Group's Enterprise-wide Risk Management Framework (ERMF) (by 30/06/06)

Risk-based Pricing (RBP) & Customer Value Mngt (CVM)

- Complete RBP / CVM projects in all 3 business clusters (by 31/03/06)

Strategic & tactical response to Basel 2

- Integrate Basel 2, Economic Capital & Capital Management into 2005 Strategic Planning Process (by 31/10/05)
- Execute agreed management actions (by 2005 / 2006 / 2007)

Project 100 % (all other Nedbank Group subsidiaries).

- Complete Basel 2 work at smaller subsidiaries (by 30/06/06)

Key Basel 2 deliverables (*continued*)



REMAINING KEY DELIVERABLES

Change Management
-Incl education, documentation & communications

- Ongoing Change Management
- Ongoing upskilling, resourcing, education & training
- Ongoing communications

Costs, benefits & capabilities tracking

- Ongoing costs / benefits / capabilities tracking

SARB Basel 2 requirements & liason

- SARB requirements
 - Final plan review (2005)
 - Model approval (2005)
 - AIRB approach approval (2005)
 - Pilot test runs (2006)
 - Parallel runs (2007)

Independent Audit Assurance

- Complete QAR and report (by 30/11/05)

Capital requirements - 2004



- Economic Capital
 - Methodology finalised
 - Bottom up calculations
 - Economic Capital Model built

- Risk Adjusted Performance Measurement (RAPM)
 - Design, content & piloting
 - Business unit results discussions

- Risk Appetite (Quantitative)
 - Methodology finalised
 - Earnings Volatility Model built
 - Assessment of current risk appetite
 - Group risk policies – Board approved

- Capital Management
 - Blue print developed
 - Capital Projection Model built

...above delivered successfully in Dec 2004

Capital requirements - 2005



- Economic Capital & RAPM
 - ECap / RAPM shadow based reporting (commenced)
 - Fine tune & complete minor outstanding work (by 30/09/05)

- Risk Appetite
 - Finalise group's target risk appetite (by 31/10/05)
 - Build Limit Allocation Framework (by 30/09/05)

- Capital Management
 - New Group Capital Mngt function (done)
 - Capital Mngt Framework (done)
 - Group education on risk & capital based strategic planning (Q2 05)
 - Integration into strategic planning (Q3 05)

...being integrated into 3 year strategic planning

Capital requirements - 2006



- Implementation of frameworks:
 - Economic Capital
 - RAPM
 - Risk Appetite
- IT automation of related processes
- Performance measurement & incentives effective from 2006
 - Aligned on a RAPM basis

...to be delivered in 2006



Basel 2 impacts

Basel 2 impacts



- Well positioned for Basel 2 & resultant capital requirements
- However, still uncertainties:
 - 8% vs 10% RWA pillar 1 charge
 - FIRB vs AIRB accreditation
 - Standardised approach risk weightings
 - Point-in-time vs long-run data usage for retail exposures
 - IRB approaches for equity exposures are penal
 - Definition of limits for unutilised facilities
 - Operational Risk - Alternative Standardised Approach vs Standardised Approach
 - Pillar 2 buffer % levels
 - Results of SARB's QIS4
 - Final Basel 2 calibration

...inappropriate now to make public Basel 2 impacts

Basel 2 estimated costs



TOTAL ESTIMATED COSTS

Rm

Non-IT

100

IT*

150

250

SPLIT AS FOLLOWS:

2003

39 (16%)

2004

84 (34%)

2005

90 (36%)

2006

37 (14%)

250 (100%)

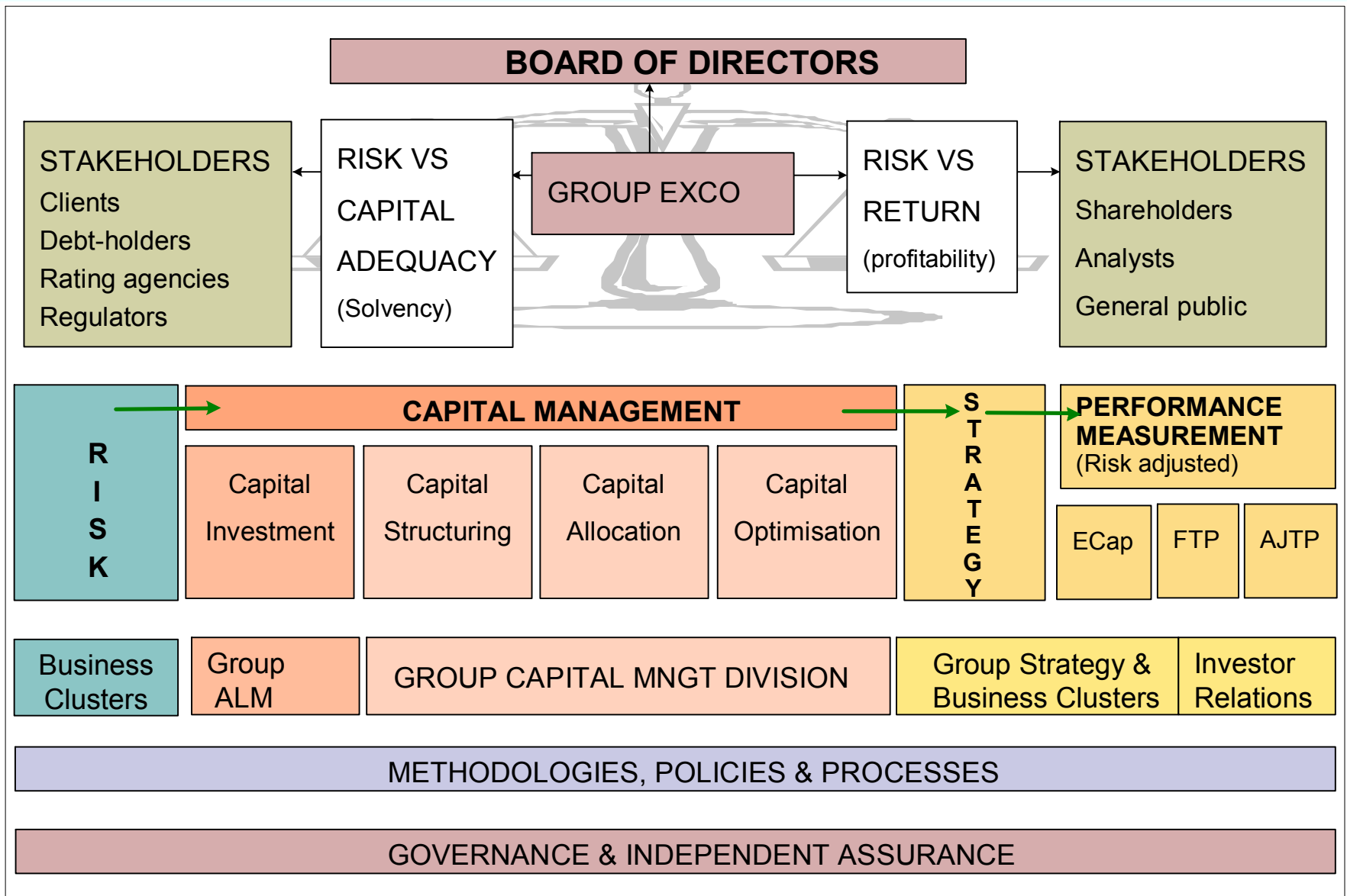
* Some integration with other major business process improvement initiatives, namely:

- Financial Process Architecture Project
- Enterprise-Wide Data Warehouse Project



New capital management framework

New capital management framework





Economic capital & risk appetite

New capital management framework



BASEL 2 (based on AIRB)		ECONOMIC CAPITAL
Pillar 1	Pillar 2	Comprehensive risk & capital assessment
Rules based	Subjective	Bottom-up modeling
Minimum capital requirements for: <ul style="list-style-type: none"> - Credit risk - Trading risk - Operational risk - Equity Risk 	Add buffer - all other material risks: <ul style="list-style-type: none"> -Interest rate risk -Concentration risk -Procyclicality -Liquidity risk? -Strategic risk? -Reputational risk?, etc. ■ Ensure capital adequacy for all material risks ■ Set risk tolerance (risk appetite) ■ Link risk, capital & strategy / business plans 	Internal capital assessment of risk for: <ul style="list-style-type: none"> ■ Credit risk (incl concentration risk) ■ Market risks <ul style="list-style-type: none"> - ALM - Trading - Investment risk (Equity) ■ Operational risk ■ Business risk <p><u>ADJUSTED FOR:</u></p> <p>Portfolio diversification benefits</p> <p><u>AND</u></p> <p>Calibrated to Group's target debt rating</p>

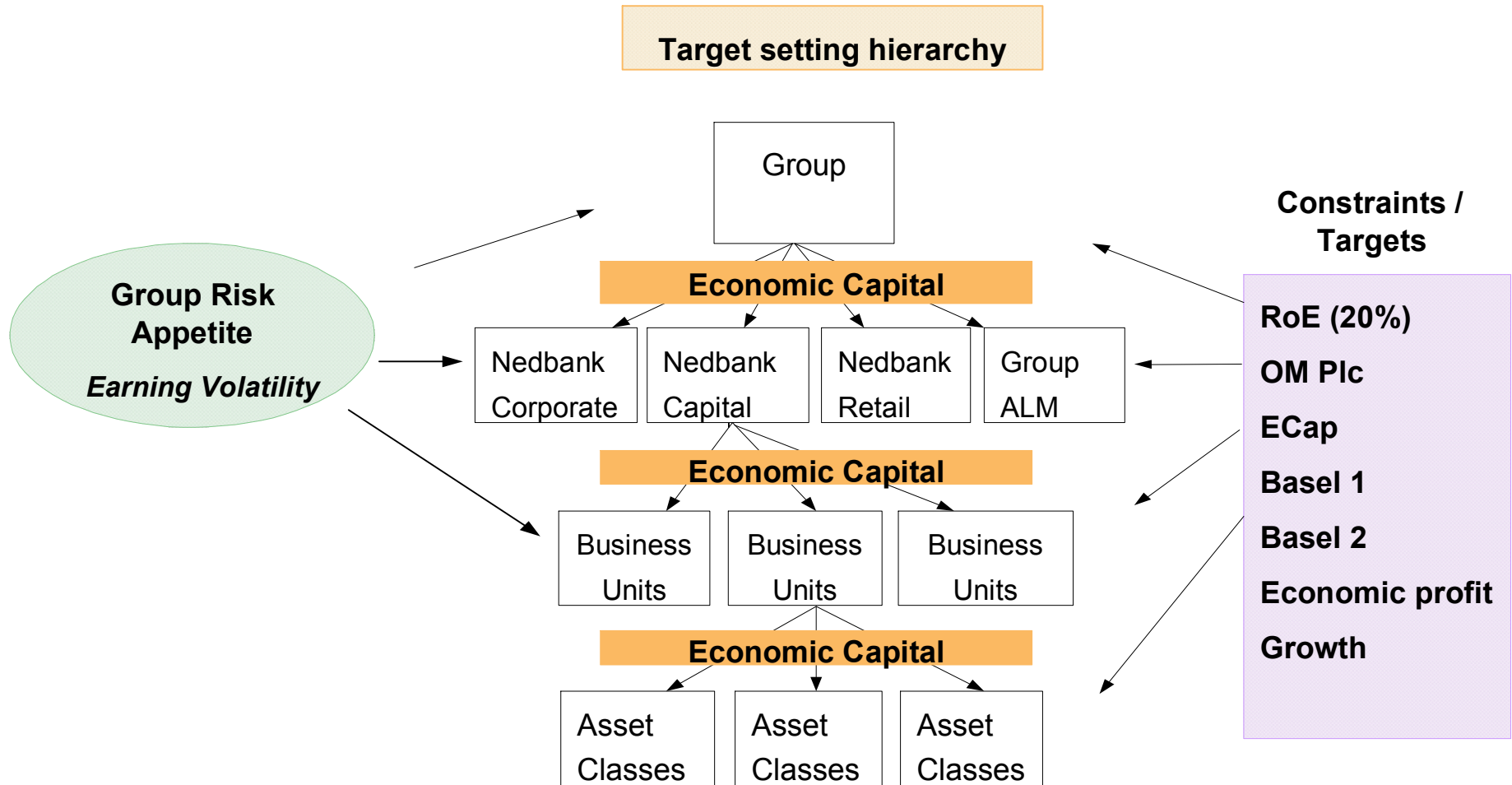
Risk appetite metrics



- Based on earnings volatility model
- 4 key metrics are used:
 - Earnings at Risk
 - Chance of regulatory insolvency
 - Chance of experiencing a loss
 - Economic Capital Adequacy / Implied Debt Rating

...aligned with our economic capital model

Economic capital & risk appetite



- Risk appetite defined in terms of earnings volatility, with risk targets subsequently allocated using economic capital



Background on RAPM & cost of capital

Background on RAPM



Lead by other areas

Funds Transfer Pricing (Group ALM)

Produces NII after transfer of A/L mismatch risk to Group ALM taking into account:

- ✎ Yield curve & maturity
- ✎ Optionality & indeterminate maturities

Activity Justified Transfer Pricing (AJTP)

Allocates expenses – to true usage of resources

"New" risk-adjusted P&L

	R
Gross Income	<input type="text"/>
Net Interest Income	<input type="text"/>
Capital Benefit	<input type="text"/>
Other (NIR)	<input type="text"/>
- Expected Loss	<input type="text"/>
- Expenses	<input type="text"/>
= Risk-adjusted Profit	<input type="text"/>
÷ Economic Capital (ECap)	<input type="text"/>
= RAROC	<input type="text"/>
x ECap - (Cost of Capital x ECap)	<input type="text"/>
= Economic Profit	<input type="text"/>

Lead by Group Capital Management Division

Capital Benefit

Notional return on economic capital allocated

Expected Loss

Substitutes for provisions

Economic Capital

Bottom-up internal measurement of risk consumed by businesses, much more accurate than Basel 1

Capital Asset Pricing Model (CAPM)

- Move to Risk-Adjusted-Performance-Measurement (RAPM) as a key basis for internal performance measurement from 1 January 2006 (with shadow roll having commenced in Q1 2005).

Cost of Capital



As at 1 January 2005

Cost of Capital is the weighted average of the cost of the two equity components: ordinary & preference shares (“WACC”)

	<u>Weighting</u>	<u>Cost</u>	<u>WACC</u>
Cost of ordinary shares (after tax)	83%	14.2%*	
<ul style="list-style-type: none"> ■ Capital Asset Pricing Model (CAPM)* 			
Cost of preference shares	17%	8.25%	
<ul style="list-style-type: none"> ■ 75% of Nedbank prime interest rate 			
			13.2%

* Bond used	Bond yield	Beta	Risk premium	After-tax cost of ordinary shares
R153	8.525%	0.95	6.0%	14.2%

...cost of capital is updated semi-annually



Capital levels & targets

Capital levels & targets



- Capital levels & planning is assessed across 5 dimensions:
 - Regulatory (Basel 1) – local (SA) & international (small)
 - Regulatory (Basel 2)
 - Economic Capital (Rating Agencies capital)
 - Statutory Capital (basis for ROE to 2007)
 - Buffer Capital
- Current regulatory (Basel 1) projections to 31 December 2005:
 - Tier 1 >8% & Total >12% (both Group & Bank)
- 3 year capital planning reflects:
 - Sound internal capital generation
 - Sound positioning for Basel 2 (AIRB) & Economic Capital

Capital levels & targets *(continued)*

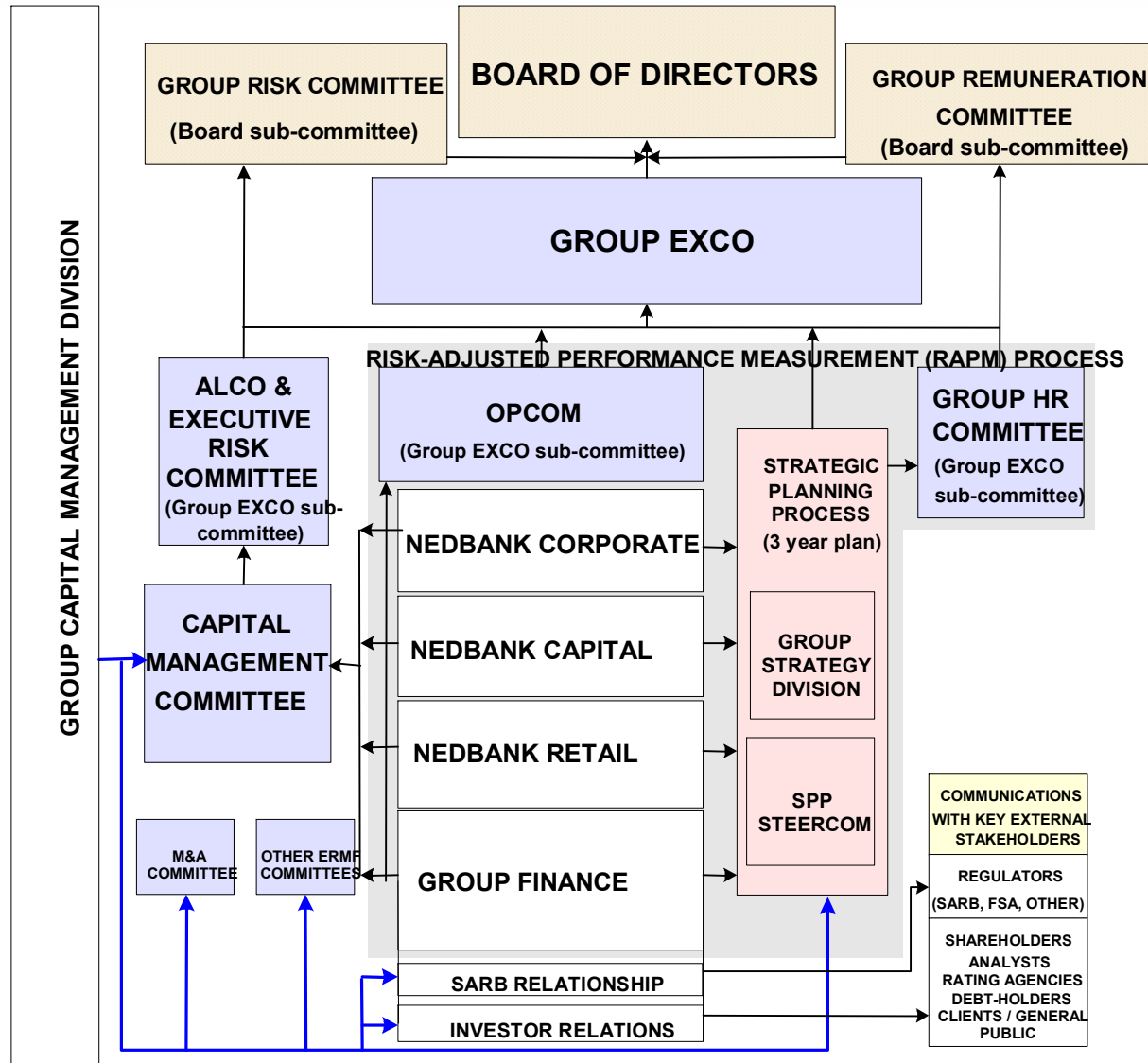


- Foreign capital requirements
 - Reduced to US\$ 342m equivalent
 - 2005 strategic planning process will finalise offshore requirements
- Current dividend policy: 3 - 3.5x cover on headline earnings
- Capital optimisation to receive strong focus in H2 2005 onwards
 - E.g. securitisation, preference shares, roll-off of Ned1 & Ned2's, etc
- Considering impact of low inflationary environment on growth, capital requirements & long-term strategy
- BEE deal is capital neutral



Integration of capital management into strategy

Integrating capital mngt into strategy



Capital – key strategic actions



- Economic capital allocation & RAPM
- Reduce / optimise risk profile of balance sheet
- Client selection improvement
- Collateral mngt improvement
- Limit mngt improvement
- FSC – think “out the box”
- Risk based pricing

- Client value mngt
- Risk based strategic planning
- Integration of risk, capital & strategy, linked to performance
- Risk adjusted profitability - determines growth areas
- Strategic capital plan
- Credit risk transfer / securitisation
- Entry of non-bank “specialists



Summary & conclusion

Summary



- Proactively responding to “the new rules to the game of banking”
- Significant progress made & on track for Basel 2
- Basel 2 impacts – pending SARB decisions before concluding
- Significant enhancements around Capital Management
 - New dedicated Group Capital Management function - advanced capabilities
 - New capital management framework
 - Integration of capital management into strategy
 - Economic Capital / RAPM in shadow roll-out
- Capital adequacy projections sound under Basel 1, Basel 2 & ECap
- Significant progress on foreign capital position

Conclusion



WINNERS

- Banks that see Basel 2 as a means to change
 - Embrace 'best practice' management science
 - Address portfolio economics
 - Increase transparency
- Banks that bring a solution to areas that will come under credit strain (e.g. FSC lending)
- Banks that exploit profitability skews

LOSERS

- Banks who see Basel 2 as a compliance exercise
 - Fail to address portfolio economics
 - Fail to improve transparency
- Late starters will have their portfolios cherry-picked
- Banks that rely on volume growth with disregard to fundamental economics implied by Basel 2



“There is no miracle moment. Small incremental wins in one common direction will restore Nedbank Group to a highly rated & respected financial institution.”





Questions?



Thank you