

## Risk management and control

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## Risk management and control

### Introduction

Managing risk effectively in a diverse and complex organisation such as the Standard Bank Group requires a strong risk management culture. Our culture supports sound commercial decision-making that adequately balances risk and reward.

### Risk management approach

The group's risk management approach is based on a combination of strong risk oversight at group level and independent risk management structures within the business units.

During 2005, the group's risk management structures, policies and processes were reviewed. The process of updating them is underway. In future all principal risks will be subject to overarching governance standards. All standards are to be applied consistently across the group and owned by the group risk management committee (GRMC), in line with the group's minimum control requirements for each risk type.

The standards will form an integral part of the group's governance infrastructure, reflecting the expectations and requirements of the board in respect of key areas of control across the group.

The standards will ensure alignment and consistency in the way that prevalent risk types are managed across the group with regard to:

- identification;
- measurement;
- management and control; and
- reporting of risk.

The standards will underpin the group's risk governance principles, which are:

- **Shareholder value based**

The group's primary objective is to protect and enhance shareholder value. As such, this objective drives the group's system of internal control.

- **Embedded**

The culture of the group reflects its appetite for risk. A suitable organisational structure, policies and procedures, and appropriate staff training are in place to enable risk to be managed at all levels of the business.

- **Supported and assured**

The system of governance and internal control provides management with assurance that risks are being managed appropriately. The board of directors regularly receives and reviews reports on governance and control processes.

- **Reviewed**

The board of directors undertakes a specific review of the effectiveness of the internal control system and risk management processes at least annually.

### Major risk categories

Risks to which the group is exposed can be classified into the following major categories:

- **credit risk** – arises from customer or counterparty non-performance or default;
- **country risk** – arises from the uncertainty that obligors in a particular country may not be able to fulfil their obligations to the group because of political or economic conditions in that country;
- **liquidity risk** – arises if any of the banks in the group have insufficient funds or marketable assets available to fulfil their future cash flow obligations;
- **market risk** – arises from a decrease in the market value of a portfolio of financial instruments caused by an adverse move in market variables such as equity, bond and commodity prices, currency exchange rates, interest rates and credit spreads, and implied volatilities on all of the above;
- **operational risk** – results from inadequate or failed internal processes, people and systems or from external events;
- **compliance risk** – arises from regulatory sanctions, financial loss, or loss to reputation as a result of failure to comply with applicable laws, regulations, codes of conduct and standards of good practice;
- **reputational risk** – results from damage to the group's image, which may impair its ability to retain and generate business;
- **insurance-related risks** – are unique to the business of life insurance, including investment and underwriting risks. The group is exposed to insurance-related risks through its effective 30% shareholding in Liberty Life and short-term insurance activities; and
- **taxation risk** – that the group will incur a financial loss due to an incorrect interpretation and application of taxation legislation or due to the impact of new taxation legislation on existing business.

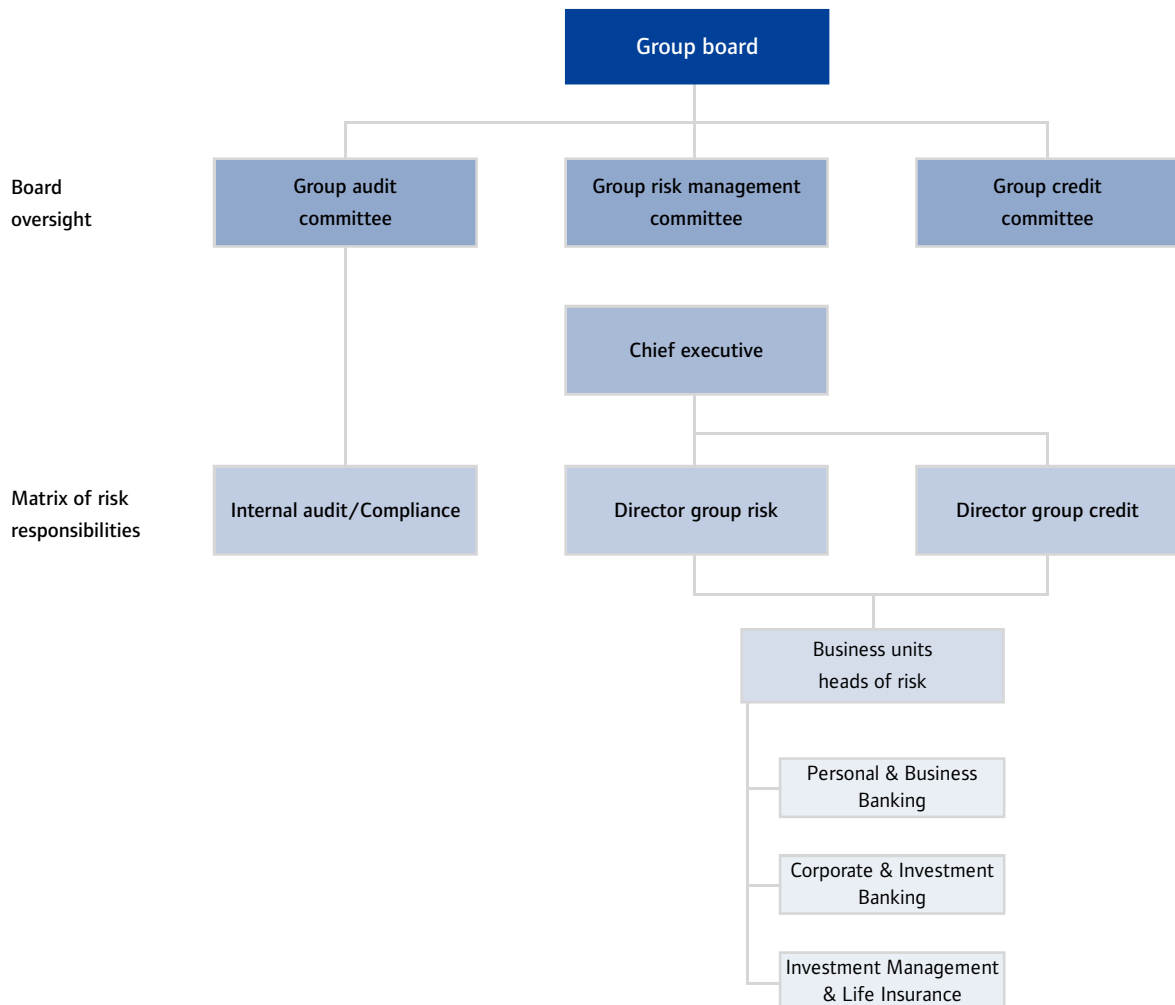
For financial institutions, a combination of these major risks occurring at the same time would be the most likely cause of significant losses. It is therefore important to ensure a holistic risk management approach – that risk types are not managed in isolation. This approach is followed at a business unit as well as group level.

### Risk responsibilities and governance structure

Due to the nature and complexity of, and risk inherent in, the group's activities, a robust risk management structure is in place to ensure adequate oversight. The principal responsibilities set out below extend throughout the group:

- the board of directors reviews and accepts the risk profile appropriate to the group's growth strategy, and requires that management maintains an appropriate system of internal control. The board delegates risk-related responsibilities to three committees, the group risk management committee, the group audit committee and the group credit committee;
- the director, group risk is responsible for setting a framework that ensures effective risk management and control for all risk types excluding credit and country risk, within the group;
- the director, group credit is responsible for setting a framework that ensures the effective management and alignment of credit risk, including country risk, within the group;
- in each business unit, the heads of risk are responsible for developing and implementing risk policies and procedures specific to their business unit's risk profile but in compliance with the group's overarching governance standards, as well as managing risk and risk reporting to relevant committees;
- risk type heads are appointed for each risk area and are responsible for coordinating and managing a specific risk type within their business unit;
- group internal audit independently audits the adequacy and effectiveness of the group's risk management, control and governance processes. The director: group internal audit reports and provides independent assurance to the group audit committee and has unrestricted access to the chief executive and chairman of the board; and
- group compliance is an independent core risk management activity. The director: group compliance reports to the group audit committee and has unrestricted access to the chief executive and chairman of the board.

The group's governance structure and risk responsibilities matrix is summarised in the diagram below.



## Risk management and control *continued*

### Risk appetite and risk tolerance

Risk appetite is the quantum of risk the group is willing to accept in the normal course of business in pursuit of its strategic and financial objectives. Risk taken within "appetite" may give rise to expected losses, but these should be covered by expected earnings.

Risk tolerance is an assessment of the maximum risk the group is willing to sustain for short periods of time. It emphasises the "downside" of the risk distribution, and the group's capacity to survive unexpected losses. The capacity to take unexpected losses depends on having sufficient capital and liquidity available to avoid insolvency. Risk tolerance typically provides a useful upper boundary for the group's risk appetite.

The board has delegated its risk-related responsibilities primarily to three committees, the group risk management committee, the group audit committee and the group credit committee, with each committee focusing on different aspects of risk management.

The process to quantify risk appetite is being reviewed and is discussed later in this report.

### Basel II

The Basel II Capital Adequacy Framework (Basel II) aims to incentivise banks, through lower capital requirements, to improve their risk management processes.

In June 2004, the Bank of International Settlement released the final version of Basel II. The revisions focused mainly on improving the quantification and management of credit and operational risks, enhancements to the supervisory review process and more extensive risk disclosure.

The South African Reserve Bank (SARB) has announced that the South African implementation date of Basel II will be 1 January 2008, with local banks and the regulator evaluating the impact of the new framework on capital requirements and risk management processes during a parallel run to be conducted for a year prior to implementation (i.e. commencing on 1 January 2007).

The group is currently working towards meeting the "advanced approaches" requirements for all risk categories. The approaches on commencement will be Advanced IRB (Internal Ratings Based) for Personal & Business Banking, Foundation IRB for Corporate & Investment Banking and standardised approach for operational risk. A detailed migration plan for all the entities across the group has been prepared for approval by the SARB. The group's Basel II programme of initiatives is on track to meet the regulatory timeline of January 2008.

Progress has been significant in aligning Probability of Default (PD) for credit risk rating models with Basel II specifications. Loss Given Default (LGD) and Exposure At Default (EAD) models are being tested and validated by way of initiatives that focus on enhancing the group's own internal data history by analysing world-wide external data. As LGD significantly impacts the level of capital required under Basel II, much focus is being placed on ensuring that collateral and other credit risk mitigations meet the Basel II eligibility criteria. The group will however be able to

leverage off recent investments in sophisticated collateral and collections management systems.

The group's operational loss database has been in use since 2003. It is being supplemented with risk and control self-assessments and Key Risk Indicators (KRIs) in the identification and monitoring of operational risks in line with Basel II requirements. No significant additional initiatives are required to achieve Basel II market risk compliance for the group. Applications for regulatory approval for internal models for market risk are in progress and other aspects such as changes to regulatory reporting are being addressed.

The implementation of Basel II across the group's geographically diverse operations is a major challenge, as the group has to meet the requirements of 30 regulators world-wide. Focus has been placed on raising awareness of Basel II even in countries where it will not be adopted. This will enable the group to meet the SARB requirement for group-wide implementation.

The group continues to participate in industry consultations on the development and implementation of Basel II and has 30 representatives involved in 23 SARB Basel II task groups.

### Implications of Basel II for the group

#### Capital

Based on the regulatory and other internal quantitative studies conducted by the group, the overall regulatory capital requirement is expected to remain largely neutral. Changes to the capital requirement within the different portfolios are however observed, i.e. the capital for the Personal & Business Banking portfolio (with regard to credit risk) will be substantially lower but this will be offset by the new capital charge for operational risk, as well as by the increase in the capital requirement for Corporate & Investment Banking in emerging markets. The group continues to assess any potential impact as outstanding areas of uncertainty around the Basel II accord are clarified and continues to participate in the efforts to refine these future capital standards.

#### Processes and systems

In addition to meeting Pillar 1 (minimum capital) requirements, processes and systems solutions are being implemented to address the Pillar 2 (supervisory review) and Pillar 3 (disclosure) requirements in terms of governance, stress testing and scenario planning, internal capital adequacy assessment, regulatory reporting and disclosure. A leading industry capital calculation solution is being implemented which will leverage off the risk systems investments made by the business entities.

#### Business benefits

The cost estimate for the Basel II implementation up to January 2008 will be in the region of R250 million. These costs can be attributed mainly to the significant strategic investment in risk IT architecture and solutions and includes a number of projects that would have been initiated regardless of Basel II imperatives. These investments will enable sophisticated portfolio analysis and scenario planning. Direct benefit will be derived from the enhancement of collateral management and collections processes,

through the minimisation of credit losses. Other business processes also benefit from the enhanced information availability, for example, new product development, pricing and provisioning.

## Risk management in main risk types

### Credit risk

Considerable resources, expertise and controls are in place to ensure efficient and effective management of credit risk.

In lending transactions, credit risk arises through non-performance by a counterparty for facilities used. These facilities are typically loans and advances, including the advancement of securities and contracts to support customer obligations such as letters of credit and guarantees. In trading activities, credit losses arise due to non-performance by a counterparty for payments linked to trading-related financial obligations.

There are three components to credit risk:

- settlement risk – arises in transactions involving the non-simultaneous exchange of values when the group honours its obligations to deliver value and the counterparty does not;
- pre-settlement risk – arises where a counterparty is unable or unwilling to honour its future obligation. The group is then exposed to replacement cost risk when it subsequently arranges a transaction with a second counterparty to replace the defaulted deal; and

- issuer risk – arises where the issuer of a debt instrument defaults on a particular principal payment or set of payments due under the instrument or where an equity instrument collapses in price.

Market risk and credit risk overlap in traded credit products (whether traded as principal or held as collateral) including debt instruments and credit derivatives. In these circumstances, issuer concentration and default risks are managed through credit and country risk processes, and market price sensitivity through market risk processes.

### Approach to managing credit risk

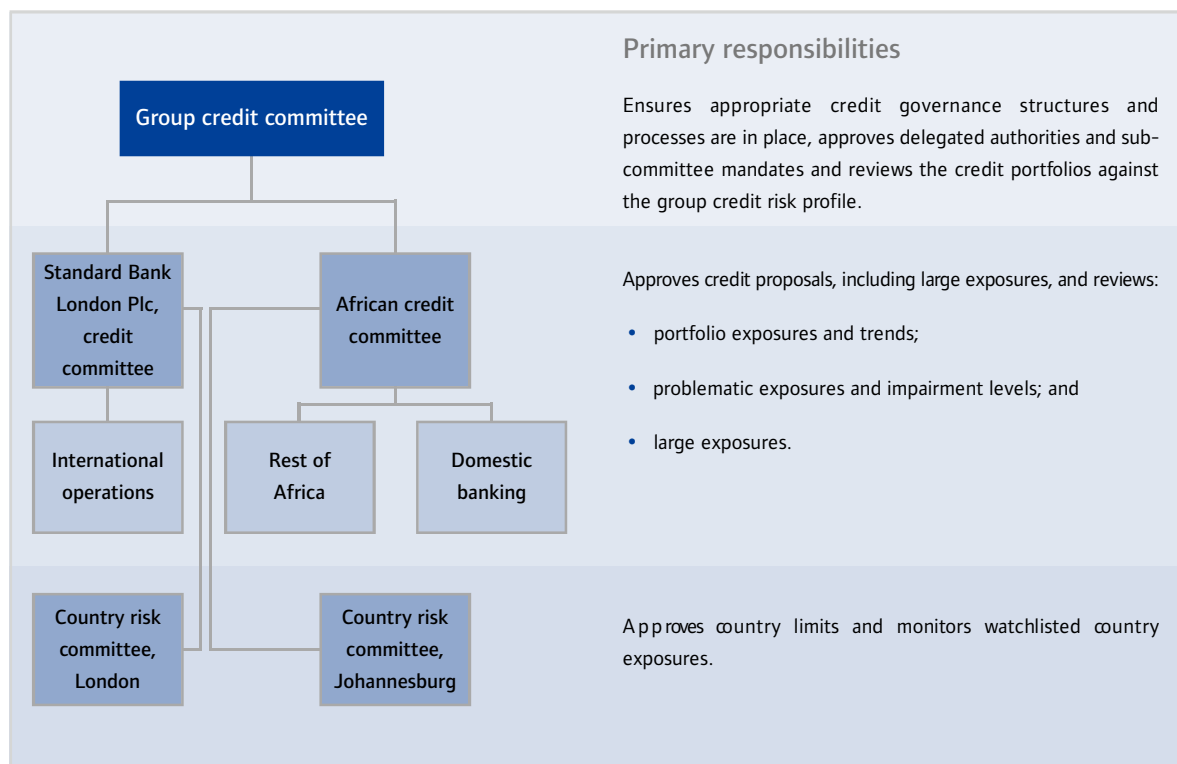
Credit risk is managed by means of a governance structure with clearly defined mandates and delegated authorities. The group credit committee delegates authority to the African and Standard Bank London Plc credit committees for the approval of credit proposals. These committees further delegate authority within their limits. The delegated authorities are documented and take into consideration credit quality, size of facility, and committee representation.

The primary responsibility for credit risk lies with the director, group credit. He is responsible for coordinating the management of credit risk and ensuring the level of risk is maintained within the approved credit risk profile across the group.

Credit risk heads have been appointed for both Personal & Business Banking credit (including SMEs) and Corporate & Investment Banking credit.

In the year under review the credit risk committee structure was as follows:

### Credit risk committee structure



## Risk management and control *continued*

### Credit risk management in the business units

#### Corporate & Investment Banking

Credit exposure to sovereign states, corporates and financial institutions is usually in the form of short- and long-term loans and advances, advancement of securities and contracts to support customer obligations, such as letters of credit and guarantees, and exposures created through derivative contracts. In these instances, credit risk management is characterised by a close working relationship between the counterparty, the customer relationship team and an independent credit officer. Credit decisions are based on an in-depth knowledge of the counterparty and the industry in which it operates, as well as an assessment of the creditworthiness of the counterparty based on a review of audited financial information and underlying risk parameters.

The use of sophisticated credit rating modelling techniques, combined with an in-depth knowledge and understanding of each customer, is essential in assessing the credit risk of each counterparty dealt with. To this end, a common credit rating framework has been developed to house credit rating models for each counterparty type. The probabilities of default produced by these models are an important component of the formal credit assessment process for new and existing business. In addition, these models form the basis for continual monitoring of changes in credit quality. The validation and ongoing enhancement of these models remains a focus area. Initiatives to advance credit management practices include the enhancement of default management and collateral management systems. Together these initiatives will allow the group to understand and manage the risk of the credit portfolio more dynamically, and to meet the requirements of Basel II.

#### Personal & Business Banking

Credit exposures include lending to individuals in the form of mortgage loans, credit card facilities, personal loans, overdrafts

and asset finance facilities, as well as lending to small and medium-sized businesses.

The underlying method for credit extension is determined by the nature of the product and the strength of historical data available. In the case of individuals, and selected small and medium-sized businesses, application and behavioural scoring techniques are widely applied throughout the credit life cycle. In all other cases conventional and intuitive methods are applied to loans with decisions taken in a centralised environment strategically placed within provinces, countries and regions.

A diverse range of performance analysis techniques are applied across product sets in recognition of differing asset and maturity profiles. Defaulting accounts receive prompt attention, and in instances where loss is anticipated, are handled centrally by collection functions. Collections are a key component of the credit cycle and the underlying philosophy is to collect appropriately and promptly, using available technologies as the principal driver. The various credit portfolios are monitored regularly to evaluate the level of risk assumed against expected risk levels.

#### Credit risk on trading activities

The group enters into forward, swap and option contracts, both exchange-traded and over-the-counter, on a range of underlying instruments. Counterparties to these contracts may be the consumer market, corporate companies, other financial institutions or market professionals. The contracts enable the group and its customers to manage (reduce, take-on or eliminate) their foreign exchange, interest rate, credit, commodity, precious metal and equity risks.

To the extent that a derivative contract requires performance by the counterparty at a future date, it may create credit risk for the group. This is mitigated by master-netting agreements, such as International Swaps and Derivatives Association (ISDA) agreements, between the group and its counterparties, which permit the offset

#### Credit exposure related to derivative financial instruments at 31 December (Rm)<sup>1</sup>

	Current credit exposure		Potential credit exposure	
	2005	2004	2005	2004
<b>Foreign exchange contracts</b>				
Less than one year	4 291	6 126	6 235	9 218
One to five years	3 361	1 100	2 913	1 718
More than five years	3 338	415	4 068	769
<b>Interest rate contracts</b>				
Less than one year	324	563	6 368	8 727
One to five years	781	1 691	9 072	11 630
More than five years	909	887	8 426	24 821
<b>Commodities and other</b>				
Less than one year	17 511	2 475	32 400	6 642
One to five years	4 081	911	7 042	2 107
More than five years	85	869	643	347
<b>Total</b>	<b>34 681</b>	<b>15 037</b>	<b>77 167</b>	<b>65 979</b>

<sup>1</sup>The exposures for Rest of Africa have not been included in the above table. The amounts involved are not material in a group context.

of amounts due from, and due to, a counterparty in the event of default. Master-netting agreements are enforceable in the jurisdictions of most of our major counterparties. Entering into collateral arrangements with many of our counterparties provides further protection against default.

Credit risk exposure on derivatives and foreign exchange contracts is measured in terms of current exposure and potential future exposure, which are explained below.

- Current credit exposure represents the loss to the group assuming the customer defaults at the time the exposure is being measured.
- Potential future credit exposure represents an estimate of the potential loss to the group assuming the counterparty defaults at some future date over the remaining term of the transaction. Potential credit exposure is estimated by simulating the impact of expected changes in market rates over the life of the contract using either simple add-on factors or more complex simulation techniques.

**Credit risk measurement**

**Probability of default – internal risk ratings**

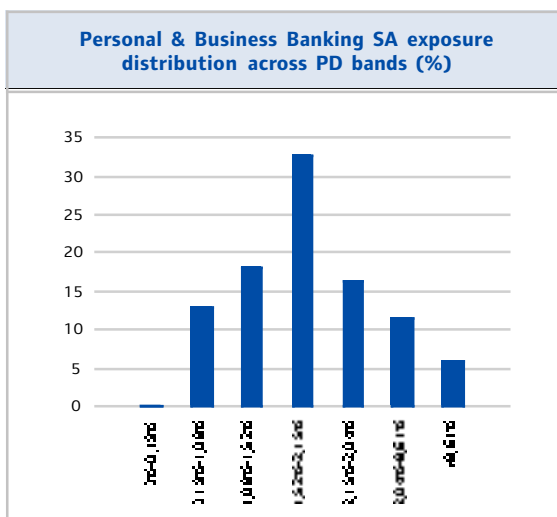
The group has developed rating models for all banking facilities. These models are used to assist the group in front-line credit decisions on new commitments and in managing the portfolio of existing exposures. The group assesses the credit quality and assigns an internal risk rating to all borrowers and other counterparties, including consumers.

**Banking book credit exposures**

**Risk profile of customer exposures**

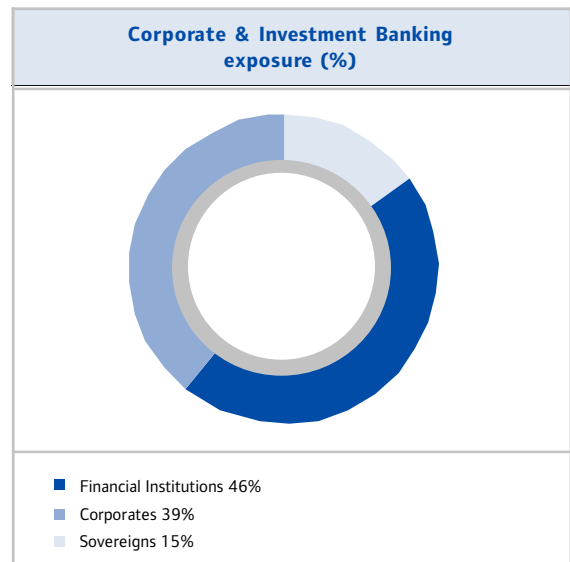
*Personal & Business Banking SA portfolio*

The graph below shows the exposure of the scored Personal & Business Banking SA portfolios (other than for SME lending) across PD bands.



**Corporate & Investment Banking portfolio**

The Corporate & Investment Banking portfolio includes primary and contingent exposure to counterparties across instruments in the banking book, and is divided into three major categories, being financial institutions, corporates and sovereigns, as detailed in the graph below.



91% of the sovereign exposures in the graph above are to the South African Government.

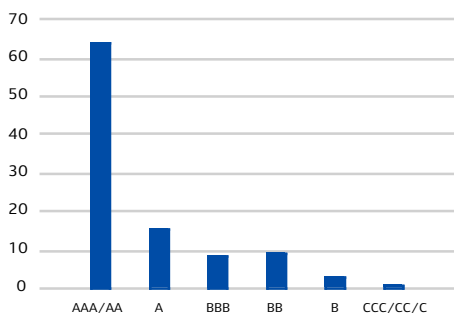
The group is now using an internationally comparable rating scale to aggregate exposures across its Corporate & Investment Banking portfolio as detailed below.

International rating	Banks PD bands (%)	Other PD bands (%)
AAA/AA/A	0 - 0,035	0,0005 - 0,0621
BBB	0,065 - 0,208	0,1235 - 0,4357
BB	0,356 - 0,961	0,7739 - 2,1850
B	2,322 - 3,466	3,4768 - 7,9144
CCC	7,128 - 13,214	15,7018 - 27,3347
CC/C	17,326 - 22,173	34,4325 - 42,1267

Where an exposure is in the local currency and is not cross-border (i.e. the Standard Bank entity and obligor have the same domicile) then an internationally comparable local rating is used. The PD associated with these ratings will be a component of the group's internal ratings-based application under Basel II.

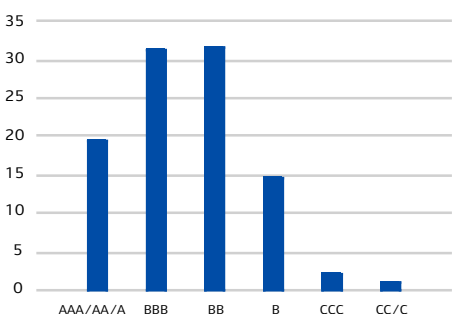
Risk management and control *continued*

**Financial institution exposures by international rating (%)**



Financial institution exposures mainly comprise placements and pre-settlement risk to domestic and international money centre banks, which the group uses to deploy its surplus liquidity and as counterparties in foreign exchange, derivatives, and commodity transactions. Sub-investment grade exposures are typically to the larger banks in emerging market countries, where the rating is capped at the country ceiling, or trade finance and capital markets business with smaller banks.

**Corporate exposures by international rating (%)**

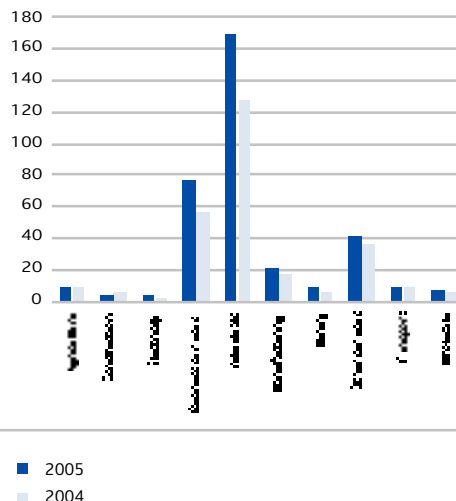


Some 70% of Corporate & Investment Banking's corporate exposures are domestic. The balance is diversified across a broad range of industries and a large number of countries. The group makes extensive use of physical and financial collateral to mitigate corporate credit risk.

**Industry analysis**

The group analyses its customers per industry using SARB categories as shown in the following graph. Going forward, the industry analysis will also be done using the International Standard Industrial Classification (ISIC) codes.

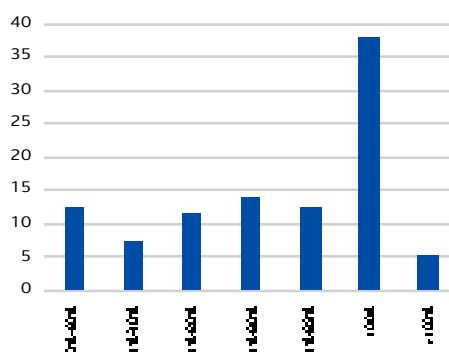
**Customer loans and advances by industry (Rm)**



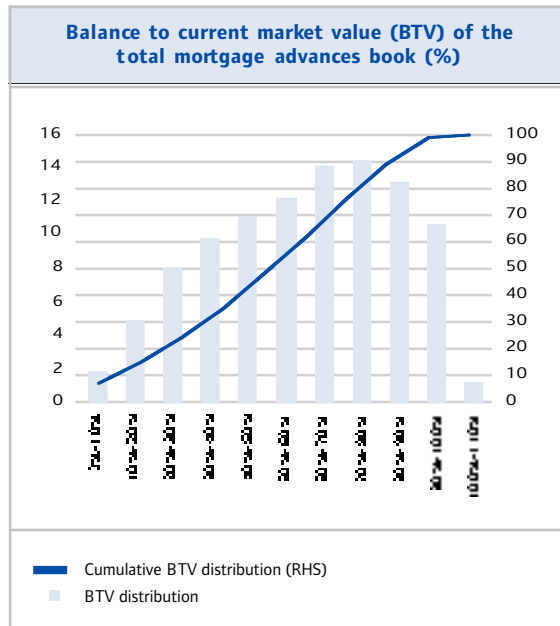
The group's largest industry exposure is to mortgage advances in Personal & Business Banking, which is included in the "individuals" category above. This exposure comprises a high number of accounts and has been a high growth area over the last five years.

In respect of the mortgage advances portfolio, the graph below shows the distribution of the loan-to-value ratios of each loan based on the value of the respective mortgaged properties as determined at the time of the last credit decision.

**Granted loan-to-value (LTV) distribution of the total mortgage advances book (%)**

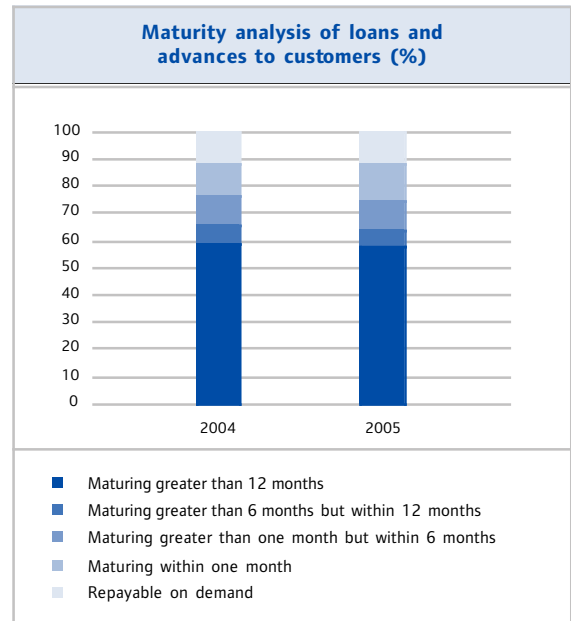


Many customers request the highest possible bond to be registered with a resulting high loan-to-value ratio. In addition, due to the sharp increase in property prices over the past few years, the current loan-to-value ratios will generally be considerably lower than they were at the time of registration. This impact is reflected in the graph below.



**Maturity analysis of the banking book for the group**

An analysis of contractual maturity is set out in the graph below. Almost 60% of the loans to customers have a maturity of more than 12 months, the majority of which are mortgage advances.



The current market values used above have been calculated using a valuation model that considers property price inflation.

**Loan impairments**

**Non-performing loans (NPLs) and special mention loans**

A high-level summary of total loans and advances is provided on the following page and has been prepared in accordance with the SARB guidelines set out below.

Standard and current	Items that are fully current and the full repayment of the contractual principal and interest amounts are expected.
Special mention	Items for which the borrower is experiencing difficulties. Ultimate loss is not expected but could occur if adverse conditions persist.
Sub-standard <sup>1</sup>	Items that show underlying well defined weaknesses that could lead to probable loss if not corrected. The risk that these items may be impaired is probable and the group relies to a large extent on the available security.
Doubtful <sup>1</sup>	Items that are considered to be impaired, but are not yet considered final losses because of some pending factors which may strengthen the quality of the items.
Loss <sup>1</sup>	Items that are considered to be uncollectable and where the realisation of collateral and institution of legal proceedings have been unsuccessful. These items are considered of such little value that they should no longer be included in the net assets of the group.

<sup>1</sup>Classified as non-performing for accounting purposes.  
 Gross NPLs are net of interest in suspense.  
 Loans and advances exclude any contingents and the derivative portfolios.

Risk management and control *continued*

## Standard Bank Group's external loans and advances in line with the South African Reserve Bank regulatory definitions

	Gross advances	Non-performing loans				Performing loans	
	Total Rm	Sub-standard Rm	Doubtful Rm	Loss Rm	Total Rm	Special mention Rm	Standard Rm
<b>2005</b>							
<b>Domestic Banking</b>	274 150	1 770	1 259	390	3 419	3 066	267 665
Personal & Business Banking SA	196 393	1 423	1 222	325	2 970	3 033	190 390
Corporate & Investment Banking SA	77 581	347	37	26	410	33	77 138
Other domestic operations	176	–	–	39	39	–	137
Rest of Africa	14 413	134	43	134	311	882	13 220
Corporate & Investment Banking International	49 359	101	–	313	414	502	48 443
Other	67	–	–	–	–	–	67
<b>Gross loans and advances</b>	<b>337 989</b>	<b>2 005</b>	<b>1 302</b>	<b>837</b>	<b>4 144</b>	<b>4 450</b>	<b>329 395</b>
<b>Percentage of total book (%)</b>	<b>100,0</b>	<b>0,6</b>	<b>0,4</b>	<b>0,2</b>	<b>1,2</b>	<b>1,3</b>	<b>97,5</b>
Domestic Banking	100,0	0,7	0,5	0,1	1,3	1,1	97,6
Corporate & Investment Banking International, Rest of Africa and Other	100,0	0,3	0,1	0,7	1,1	2,2	96,7
<b>2004</b>							
<b>Domestic Banking</b>	216 087	1 647	1 198	406	3 251	2 399	210 437
Personal & Business Banking SA	153 141	1 142	1 101	321	2 564	2 380	148 197
Corporate & Investment Banking SA	62 884	505	97	43	645	19	62 220
Other domestic operations	62	–	–	42	42	–	20
Rest of Africa	12 287	95	36	77	208	581	11 498
Corporate & Investment Banking International	34 286	124	192	135	451	442	33 393
Other	9	–	–	–	–	–	9
<b>Gross loans and advances</b>	<b>262 669</b>	<b>1 866</b>	<b>1 426</b>	<b>618</b>	<b>3 910</b>	<b>3 422</b>	<b>255 337</b>
<b>Percentage of total book (%)</b>	<b>100,0</b>	<b>0,7</b>	<b>0,6</b>	<b>0,2</b>	<b>1,5</b>	<b>1,3</b>	<b>97,2</b>
Domestic Banking	100,0	0,7	0,6	0,2	1,5	1,1	97,4
Corporate & Investment Banking International, Rest of Africa and Other	100,0	0,5	0,5	0,4	1,4	2,2	96,4

## Analysis of NPLs per business unit balance sheet impairment

	Gross NPLs (net of interest in suspense)		Securities and expected recoveries		Net after securities and expected recoveries		Impairments for NPLs		Gross impairment coverage	
	2005	2004	2005	2004	2005	2004	2005	2004	2005	2004
	Rm	Rm	Rm	Rm	Rm	Rm	Rm	Rm	%	%
<b>Personal &amp; Business Banking SA</b>	2 970	2 564	1 855	1 406	1 115	1 158	1 115	1 158	38	45
Mortgage advances	1 702	1 375	1 373	913	329	462	329	462	19	34
Card debtors	161	104	47	30	114	74	114	74	71	71
Instalment sale and finance leases	474	463	230	226	244	237	244	237	51	51
Other personal and business	633	622	205	237	428	385	428	385	68	62
<b>Corporate &amp; Investment Banking SA</b>	410	645	168	366	242	279	242	279	59	43
Corporate & Investment Banking SA	100	314	25	188	75	126	75	126	75	40
Property finance	310	331	143	178	167	153	167	153	54	46
Other domestic operations	39	42	2	4	37	38	37	38	95	90
<b>Domestic Banking</b>	3 419	3 251	2 025	1 776	1 394	1 475	1 394	1 475	41	45
Rest of Africa	311	208	142	19	169	189	169	189	54	91
<b>Corporate &amp; Investment Banking International</b>	414	451	44	4	370	447	370	447	89	99
<b>Total group</b>	4 144	3 910	2 211	1 799	1 933	2 111	1 933	2 111	47	54
Staff home loan impairment in terms of IAS 39							90	92		
Impairments for country risk							30	64		
Credit risk inherent in off-balance sheet exposures and other asset classes							107	68		
<b>Total group impairments</b>							2 160	2 335		

## NPL coverage % to gross advances

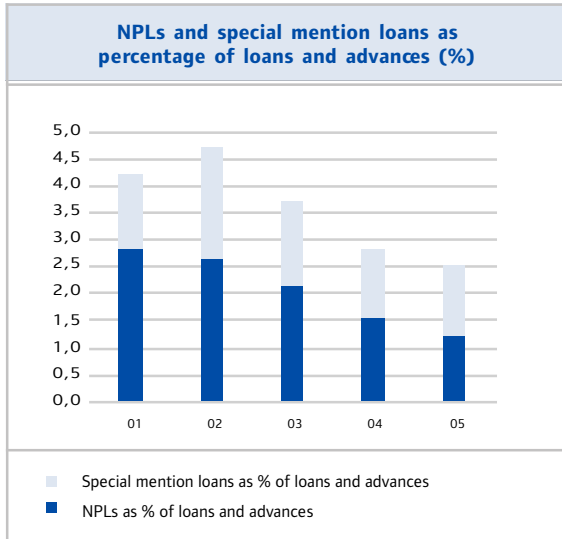
	2005	2004
	%	%
Gross NPLs	1,2	1,5
Less: Securities and collateral	(0,6)	(0,7)
Less: Impairments for non-performing loans	(0,6)	(0,8)
<b>Net NPLs</b>	<b>0</b>	<b>0</b>
Coverage: Gross <sup>1</sup>	47	54
Net <sup>2</sup>	100	100
Gross advances (Rm)	337 989	262 669

<sup>1</sup>Gross coverage = Impairment for NPLs/Gross NPL.<sup>2</sup>Net coverage = Impairment for NPLs/(Gross NPL – Security).

Risk management and control *continued*

**NPL and special mention loan percentages**

NPLs and special mention loans as a percentage of loans and advances have improved over the last five years primarily due to benign credit conditions and continuous improvements in credit lending and collection processes.

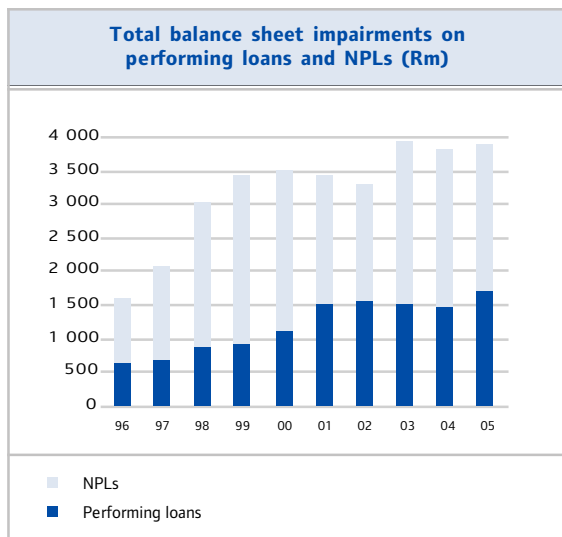


There are rigorous processes in place to determine the appropriate level of impairment for NPLs.

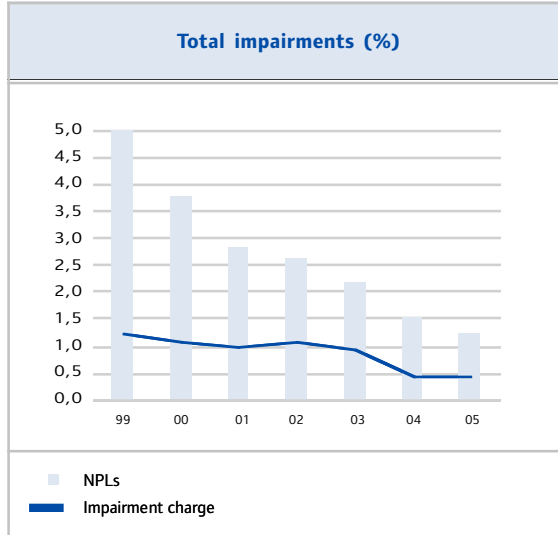
For the larger NPLs, impairments are generally determined on an individual account basis taking into account expected recoveries. Where impairments are determined on a portfolio basis, recent portfolio recovery and loss history combined with an intuitive oversight review is generally used to determine impairment adequacy.

The group impairs its performing loans and advances on an incurred loss model and is accordingly in compliance with the revised IAS 39 requirements, effective 1 January 2005.

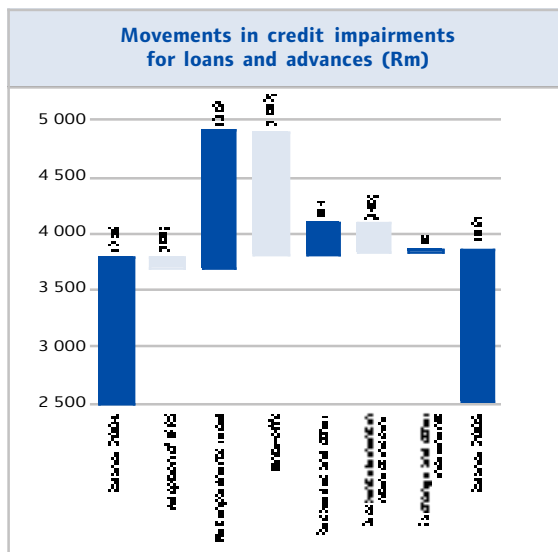
The graph below shows total balance sheet impairments for the last ten years.



The graph below details balance sheet NPLs and the income statement total impairment charge as a percentage of total loans and advances for the last seven years.



The graph below details the movement during 2005 of total balance sheet credit impairments.



## Country risk

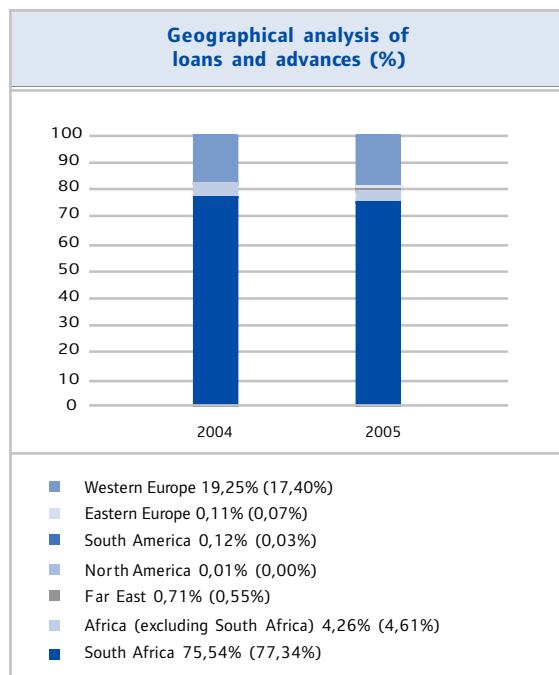
Country risk is the risk of loss arising when political or economic conditions or events in a particular country reduce the ability of counterparties in that country to meet their financial obligations to the group.

Country risk is monitored through reviews of economic and political data by the country risk teams based in Johannesburg and London. The group uses its extensive network of representative offices and subsidiaries, travels to countries when necessary and uses external sources of information to assess each country to which it is exposed.

A country-rating model is used across the group to determine the relative ranking of each country. The internal model is continuously updated to reflect economic and political changes in individual countries. The results of this process are compared with those of reputable rating agencies to validate the consistency of our model.

Mitigants such as political risk insurance are used to reduce country risk as appropriate.

The geographical analysis of loans and advances shown in the graph below is based on the location of the office recording the transaction.



## Liquidity risk

### Liquidity risk management framework

The nature of banking, investment and trading activities results in a continuous exposure to liquidity risk. Liquidity obligations arise from requirements to repay deposits, advance committed funds, and make interest and other expense payments. The group's liquidity risk management framework is designed to identify, measure and manage the liquidity risk position to protect the group's depositor base, maintain market confidence and ensure future growth. The group asset and liability committee (group ALCO) sets liquidity risk standards to ensure that the measurement, reporting, monitoring and management of the liquidity risks associated with Personal & Business Banking and Corporate & Investment Banking business activities across the group follow a common governance framework. Each bank within the group has an asset and liability committee (ALCO) to monitor compliance with group liquidity risk standards. Both the Africa ALCO and International ALCO report into the group ALCO, chaired by the group chief executive.

### Approach to managing liquidity

Liquidity management within the group has several elements. These include:

- maintenance of a structurally sound balance sheet with restricted mismatches between anticipated inflows and outflows within different time buckets;
- maintenance of a portfolio of liquid and marketable assets over and above prudential requirements;
- daily and forecast cash flow management;
- implementation of long-term funding strategies;
- diversification of funding;
- undertaking of regular stress testing; and
- maintenance of adequate contingency plans.

The cumulative impact of these various elements is monitored on at least a monthly basis by the group's ALCOs.

### Structural requirements

Structural liquidity limits and guidelines are set to restrict the mismatches between cash inflows and outflows in different time buckets. These limits and guidelines are set by group ALCO and conform to international best practice.

Significant sources of structural liquidity are provided by term liabilities, portfolios of highly liquid assets, as well as core consumer and corporate customer deposits, mainly in the form of current and savings accounts. Although these deposits are mostly repayable on demand, or at short notice, diversification in terms of depositors, products and instruments assists in protecting against unexpected fluctuations.

## Risk management and control *continued*

By way of illustration, the one-month mismatch guideline is a maximum net liability outflow of 5,0%, taking behavioural profiles of depositors and borrowers into account. During 2005, the average one-month liquidity gap, as a percentage of total liabilities, was 1,1% for Domestic Banking and 0% for Corporate & Investment Banking International.

Domestic Banking also observes a ratio of long-term funding, defined as those deposits where the remaining term to maturity exceeds six months, to total funding. The ratio has actively been increased from 15,8% in December 2004 to 16,1% in December 2005, thereby further enhancing a structurally sound balance sheet.

### Liquid and marketable assets

The group maintains a portfolio of highly marketable assets above the required statutory ratio that can easily be liquidated as protection against any unexpected interruption in cash flows. The average amount of surplus, unencumbered marketable assets in Domestic Banking was R22,3 billion in 2005 (2004: R18,8 billion).

### Cash flow management and long-term funding strategies

To retain and generate adequate funding, the group has implemented cash flow management strategies. The daily management of funding is achieved by monitoring future cash flows to ensure cash requirements can be met. Monitoring and reporting take the form of cash flow projections, particularly over a short-term horizon.

Funding strategies, based on forecasted balance sheet structures, are used to anticipate and plan for future funding and structural liquidity requirements. The group is committed to maintain and increase core deposits, and improve the long-term maturity profile of the deposit portfolio. Securitisation represents a relatively small portion of the group's funding strategy, but provides additional flexibility in Domestic Banking. During 2005, the group securitised R3,0 billion of vehicle loans and R4,5 billion of home loans.

### Diversity of funding

Funding diversification and the constant monitoring of depositor concentrations are other key elements of liquidity management. Diversification is maintained across counterparty, instrument, industry sector and term. To ensure that a bank does not place undue reliance on a single entity as a funding source, limits are set on the amount of deposits accepted from any one entity and from the top-ten entities. Depositor concentrations and compliance to limits are reviewed at monthly ALCO meetings. In banking operations where depositor concentration levels periodically exceed the limits set at a group level, a portfolio of unencumbered marketable assets, in excess of prudential requirements, is held to mitigate the concentration risk and cater for the possibility of significant outflows.

### Liquidity stress testing

The group's asset and liability management functions develop and implement a process for subjecting anticipated cash flows to stress scenarios, to evaluate the impact of unlikely but plausible events on liquidity positions. The scenarios are based on historical events (such as the emerging market crisis of 1998) or modelled using hypothetical events such as a rating downgrade. The output of stress testing forms the basis of the group's contingency funding plans.

### Contingency plans

The group's contingency funding plans comprise both quantitative and procedural elements. Quantitative elements include establishing the estimated value of funding sources under stress conditions, as well as selling assets under forced-sale conditions and adjusting the funding cost of liabilities. Procedural elements deal with roles and responsibilities at various levels of management, actions to be executed, as well as communication requirements, both internal (such as management information requirements) and external (such as communications with regulators).

### Market risk

Market risk exists wherever the group has trading, banking or investment positions. Major exposures to market risk occur in markets served by formal financial exchanges and over-the-counter markets. These exposures arise from customer-driven business and from proprietary positions.

### Approach to managing market risk

#### Market risk exposure on trading positions and capital funds

Market risk exposures as a result of trading activities are contained within Corporate & Investment Banking's trading operations. The board grants general authority to take on market risk exposure to the group ALCO. Group ALCO sets market risk standards to ensure that the measurement, reporting, monitoring and management of market risk associated with Corporate & Investment Banking across the group follow a common governance framework. Each bank within the group has ALCOs to monitor compliance with these market risk standards. Both the Africa ALCO and International ALCO report into the group ALCO, chaired by the group chief executive.

The group manages market risk through risk limits. The group uses a range of risk measurement methodologies and tools to establish limits, including Value-at-Risk (VaR), stress testing, loss triggers and basic risk management measures.

The group generally uses the historical VaR approach to derive quantitative measures, specifically for market risk under normal market conditions. While VaR, calculated daily, provides an indication of possible losses under normal market conditions, the group supplements VaR with stress tests. The stress testing takes into account likely events that characterise the markets in which the group operates.

The group back-tests its VaR models to verify the predictive power of the VaR calculations. Back-testing compares the daily profit and losses under the buy and hold assumption with the estimates our VaR models had forecast.

Loss triggers are designed to contain daily, monthly and year-to-date losses for individual business units by enforcing management intervention at predetermined loss levels. Other basic risk measures specific to individual business units are also used. These measures include permissible instruments, concentration of exposures, gap limits and maximum tenor.

The table below shows the aggregated historical VaR calculations for Corporate & Investment Banking in the markets in which the

group holds trading positions. The minimum and maximum VaR amounts show the bands in which the values fluctuated during the periods specified. The group calculates historical VaR with a holding period of one day and a confidence interval of 95%.

Market risk management units – independent of trading operations and accountable to business unit ALCOs – monitor market risk exposures due to trading activities. These units monitor exposures and respective excesses daily, and report monthly to ALCO and quarterly to the group risk management committee.

#### Trading book value-at-risk analysis (Rm)

Market variable	Normal VaR <sup>2</sup>				Stress VaR <sup>3</sup>		
	Maximum <sup>1</sup>	Minimum <sup>1</sup>	Average	31 Dec	Maximum <sup>1</sup>	Minimum <sup>1</sup>	Average
<b>2005</b>							
Credit derivatives	43,3	12,3	26,0	39,3	266,8	66,3	138,3
Equity – other	0,8	0,3	0,5	0,6	4,4	1,3	2,7
Foreign interest rate and foreign exchange	32,1	11,0	18,4	20,0	182,4	64,9	108,8
Energy	9,3	0,6	3,1	2,4	49,3	3,1	16,3
Interest rates – SA	16,5	6,9	11,2	14,4	214,0	64,7	129,1
Equities – SA	27,5	–	3,4	4,7	87,1	–	22,9
Base metals	8,0	0,1	3,0	5,7	42,1	0,3	15,8
Precious metals	12,9	1,4	6,2	1,9	78,1	9,5	40,0
Commodities	1,9	–	0,9	0,6	4,9	0,1	2,1
Diversification benefit <sup>4</sup>			(37,1)	(42,4)			(245,8)
<b>Aggregate</b>	<b>49,4</b>	<b>22,9</b>	<b>35,7</b>	<b>47,0</b>	<b>342,8</b>	<b>146,8</b>	<b>230,1</b>
<b>2004</b>							
Credit derivatives	46,0	10,5	33,3	29,0	223,0	96,4	156,4
Equity – other	38,4	1,9	10,8	2,2	202,6	10,3	57,1
Foreign interest rate and foreign exchange	32,4	6,3	17,9	11,0	122,2	39,2	86,9
Energy	25,5	0,1	5,4	19,0	134,9	0,8	28,3
Interest rates – SA	25,1	5,6	12,1	5,8	171,6	23,7	67,1
Equities – SA	12,3	–	0,9	5,0	97,9	–	25,6
Base metals	9,0	0,3	3,5	2,4	47,5	1,8	18,7
Precious metals	8,5	2,7	5,3	4,4	69,2	13,8	37,2
Commodities	1,7	–	0,2	0,1	5,1	0,1	0,7
Diversification benefit <sup>4</sup>			(45,9)	(37,8)			(257,9)
<b>Aggregate</b>	<b>65,3</b>	<b>28,4</b>	<b>43,5</b>	<b>41,1</b>	<b>333,2</b>	<b>141,7</b>	<b>220,1</b>

<sup>1</sup>The maximum (and minimum) VaR figures reported for each market variable did not necessarily occur on the same days. As a result, the aggregate VaR will not equal the sum of the individual market VaR values, and it is inappropriate to ascribe a diversification effect to VaR when these values may have occurred on different dates.

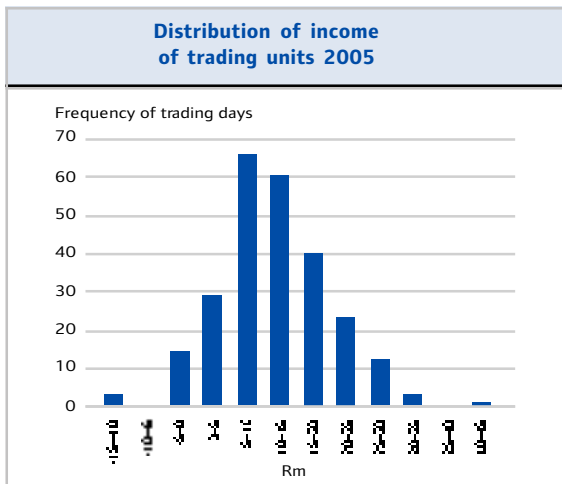
<sup>2</sup>Normal VaR is based on a holding period of one day and a confidence interval of 95%.

<sup>3</sup>Stress VaR is based on a holding period of between 10 and 20 days and a confidence interval of 99,7%.

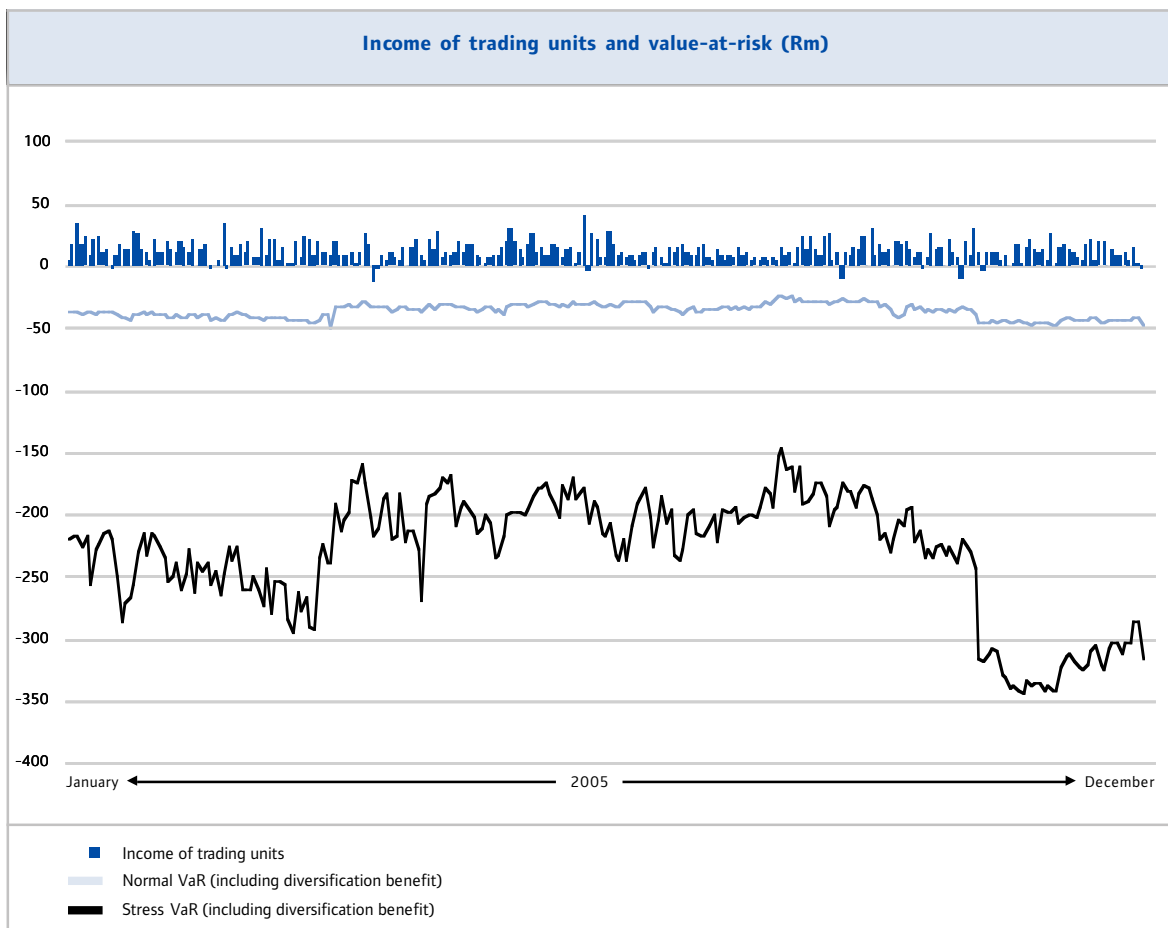
<sup>4</sup>Diversification benefit is the benefit of measuring the VaR of the trading portfolio as a whole. That is the difference between the sum of the individual VaRs and measuring the VaR of the whole trading portfolio.

Risk management and control *continued*

The graph below shows the frequency distribution of daily income during 2005. It indicates to what degree the realised income and loss distribution deviates from a normal (symmetrical) distribution. In this case the distribution is skewed to the profit side. The graph details that income of R5 million – R10 million was realised on the majority of trading days (66 days).



The graph below shows the value-at-risk analysis and actual income of trading units throughout the year.



Market risk on equity investments

Equity management committees approve investments in listed and unlisted entities within an approval limit framework. Market risk on investments is managed in accordance with the purpose and strategic benefits of such investments, rather than purely on mark-to-market considerations. Periodic reviews and reassessments are undertaken.

Market risk exposure on banking positions

Banking-related market risk exposure is primarily due to structural interest rate risk arising from the differing repricing characteristics of banking assets and liabilities. Structural interest rate risk, which is the potential adverse effect of interest rate movements on net interest income, is transferred to and managed by the group's treasury operations. Changes to the interest rate profile are achieved mainly by using derivatives, particularly interest rate swaps, where the shape of the yield curve and the group's own view of interest rates are used as inputs to defining hedging strategies.

Asset and liability management (ALM) functions monitor exposures to interest rate risk. Banking-related interest rate risk in the group's Domestic Banking operation is monitored by the ALM function in Johannesburg. Within the African operations, the in-country ALM teams monitor banking-related interest rate risk,

with oversight by the ALM function in Johannesburg. Within Corporate & Investment Banking International's treasury, banking-related interest rate risk, which is primarily in US dollars and sterling, is managed on an integrated basis together with the trading book interest rate risk, overseen by the International ALCO.

The primary banking positions of the group reside in the Domestic Banking operation. The main analytical techniques used to measure banking book interest rate risk are earnings-based measures such as forward looking dynamic scenario analyses, including Monte Carlo simulations, and static repricing gap analyses, which measure interest rate risk at a point in time, as well as valuation-based measures in the form of economic value of equity. The results obtained from these analytical techniques assist the group in evaluating the optimal hedging strategies on a risk-return basis.

The repricing gap for the Domestic Banking operation for the financial year end is shown below. All assets, liabilities and derivative

instruments are placed in gap intervals based on their repricing characteristics. Assets and liabilities for which no specific contractual repricing or maturity dates exist are placed in gap intervals based on management's judgement and statistical analysis, as applicable, based on the most likely repricing behaviour. Comparing the repricing gap as at December 2004 with December 2005, it is evident that the asset sensitivity of the Domestic Banking operation has increased. The extent of banking book interest rate exposure remains within limits set by Africa ALCO.

The Domestic Banking operation remains asset-sensitive and is therefore positioned to benefit from an anticipated rate hiking cycle. A 1% parallel increase in the yield curve is forecast to result in a favourable R415 million annualised net interest income impact, which represents 3,9% of net domestic interest income for a projected twelve-month period.

#### Repricing analysis of assets, liabilities and shareholders' funds as at 31 December 2005 (Rm)

Domestic Banking operations in South Africa	Call 3 months	4 – 6 months	7 – 12 months	Over 12 months	Non-rate sensitive	Total
<b>2005</b>						
Total assets	297 541	12 666	7 987	14 617	94 305	427 116
Total liabilities and shareholders' funds	268 846	7 079	3 364	31 584	116 243	427 116
Interest rate sensitivity gap	28 695	5 587	4 623	(16 967)	(21 938)	–
Cumulative interest rate sensitivity gap	28 695	34 282	38 905	21 938	–	–
Cumulative interest rate sensitivity gap as percentage of total assets	6,7%	8,0%	9,1%	5,1%		
<b>2004</b>						
Total assets	244 344	6 255	6 264	12 928	111 896	381 687
Total liabilities and shareholders' funds	223 693	5 798	3 804	12 070	136 322	381 687
Interest rate sensitivity gap	20 651	457	2 460	858	(24 426)	–
Cumulative interest rate sensitivity gap	20 651	21 108	23 568	24 426	–	–
Cumulative interest rate sensitivity gap as percentage of total assets	5,4%	5,5%	6,2%	6,4%		

## Operational risk

The group recognises the significance of operational risk, which is inherent in all areas of our business. Operational risk is managed within acceptable levels through an appropriate level of management focus and resources.

### Approach to operational risk management

The aim of the operational risk management function is to provide oversight and control of operational risk across the bank and to ensure that this remains within acceptable levels, based on an operational risk appetite set by the board of directors. The prime responsibility for the management of operational risk remains embedded in line management in order for the risks to be managed where they arise.

To support this, an operational risk management framework has been established to ensure that an integrated and effective risk management approach is applied consistently across the group. This framework exceeds the Basel II minimum requirements for the standardised approach and incorporates the qualitative requirements of the advanced measurement approach (AMA) to ensure a smooth conversion when and if the group decides to adopt AMA. It facilitates the identification and assessment of risks, the control of those risks and the ongoing monitoring and reporting of the operational risk profile.

## Risk management and control *continued*

Independent operational risk functions perform control and oversight, including the setting of appropriate policies, governance standards and tools, which include:

- a centralised operational loss database providing management reports used to identify improvements to processes and controls;
- risk and control self-assessment through which existing and potential future risks and their related controls are identified and assessed; and
- key risk indicators which measure specific factors to provide an early warning to proactively address potential exposures.

The group's operational risk strategy provides for continuous development to keep abreast of legislative and regulatory requirements. In addition, we continue to develop and enhance our standards, policies, methodologies and systems in line with leading practice.

The group maintains a comprehensive insurance programme to cover losses from fraud, theft and damage to physical assets and professional liability claims.

Whilst all elements of operational risk are managed diligently, key areas requiring specific focus are discussed below.

### Business continuity management

Business continuity ensures the availability of all key processes required to support essential activities in the event of an interruption to, or disruption of, business. Within the group, business continuity management has been strengthened through good governance, improved recovery plan quality and advanced levels of testing.

A group-wide simulation was conducted during 2005 and particular attention was given to testing and business continuity management within Personal & Business Banking SA. This programme, together with the 2004 initiatives conducted by Corporate & Investment Banking, has significantly advanced group-wide resilience. Going forward, focus will be placed on longer-term sustainability of recovery, including hard-core testing and the completion of contingency facilities, such as geographically separated processing centres, to enable continued business operations in the event of a disaster.

### Information risk management

Information risk is the possibility of loss or damage arising from a breach in the confidentiality, integrity or availability of the group's information. The group's information risk management practices play a key role in protecting information from a wide range of threats to ensure business continuity, minimise business damage and to maximise return on investments and business opportunities.

### Fraud risk management

Fraud risk management is applied throughout the group and is supported by the group's forensic services function that operates

under the group internal audit mandate set by the group audit committee. The strategic approach focuses on fraud prevention, detection, investigation and whistle blowing activities. The group maintains a zero-tolerance approach towards fraud and dishonesty.

### Risks associated with outsourcing arrangements

The group ensures these risks are adequately managed. This includes a structured approach to ensure:

- alignment of the outsourcing proposal with the group's business objectives and operating imperatives;
- potential risks which could arise from an outsourcing arrangement are identified and addressed;
- responsibilities for all outsourcing arrangements are clearly understood;
- all outsourcing arrangements comply with regulatory requirements; and
- all the outsourcing objectives are achieved.

## Compliance risk

The group is subject to extensive supervisory and regulatory regimes in all countries in which it operates. While executive management remains responsible for overseeing the management of the bank's compliance risk, group compliance actively engages with management and compliance officers within business units and subsidiaries to proactively support the generation of legal, ethical and profitable business. This is achieved via three service delivery streams: administration and support services; regulatory services and analysis; and monitoring.

Specialist support units aid higher exposure compliance risk requirements. The support and regulatory services ensure that management and staff are kept informed of regulatory developments and trained as necessary. The monitoring department uses a risk-based methodology, integrated with the methodologies used by the group's other risk assurance functions, to review and report on the compliance risk exposures and the efficacy of the compliance risk management system. Business units are required to report to the group function on a quarterly basis or more regularly if appropriate.

Group compliance is the prime interface between the South African regulators and the group. Bank supervision and oversight became increasingly rigorous in 2005. The Bank Supervision Department of the SARB is our lead regulator while the Financial Services Board (FSB) has jurisdiction over consumer protection issues relating to bancassurance products. In addition, our offshore operations are subject to the regulations imposed by their respective host country regulators. Key challenges locally during 2005 have continued to relate to Financial Intelligence Centre Act (FICA) requirements for the re-identification and verification of clients, and the FSB's accreditation of financial service providers.

Money laundering control and occupational health and safety (including aspects of environmental risk management) are managed

within group compliance and there are increasingly onerous legislative requirements being imposed in both these areas.

### Reputational risk

The group manages reputational risk through its evaluation and control of the major risk types as set out above. In addition, there is an open communication culture that allows for all issues to be appropriately dealt with in a timely manner.

### Insurance-related risk

The Liberty Group (Liberty) board of directors acknowledges its responsibility for establishing and communicating appropriate risk and control policies, and ensuring that adequate risk management processes are in place. Liberty has a number of committees which deal with the various policies for accepting insurance risks, including selection and approval of risks to be insured, use of limits and avoiding undue concentrations of risk, underwriting strategies to ensure the appropriate risk classification and premium levels, among others, as detailed below.

#### Responsibility for risk management

A Liberty group risk management committee, being a committee of the Liberty board, is in place to assist the board in discharging its risk management obligations.

The principal objectives of Liberty's risk management committee are to:

- review Liberty's risk philosophy, strategy, policies and processes recommended by executive management;
- review compliance with risk policies and with the overall risk profile of Liberty;
- review and assess the integrity of the processes and procedures for identifying, assessing, recording and monitoring risk;
- review the adequacy and effectiveness of Liberty's risk management and its implementation by management;
- ensure that material corporate risks have been identified, assessed and receive attention; and
- provide the board with an assessment of the state of risk management within Liberty.

A significant part of Liberty's business involves accepting and managing risk. Primary responsibility for risk management at an operational level rests with the executive committee. Management and various specialist committees are tasked with integrating the management of risk with the day-to-day activities of Liberty.

These committees are outlined below.

- **Audit and actuarial committee** – principal objectives (pertaining to risk) are as follows:
  - act as an effective communication channel between the board on one hand and the external auditors and the head of internal audit on the other;

- satisfy the board that adequate internal, financial and operating controls are being identified, addressed and monitored by management; and

- enhance the quality, effectiveness, relevance and communication value of the published financial statements and other public documentation of a financial nature issued by Liberty.

- **Capital management committee** – is responsible for the management and investment of Liberty's capital.
- **Asset/liability matching committee** – focuses on the matching of assets and liabilities. It also oversees the high-level mix parameters for various products and portfolios, and is tasked with agreeing benchmarks and mandates for performance of each investment portfolio in conjunction with the asset managers.
- **Product approval committee** – assesses whether all new products conform to Liberty's predetermined requirements and standards, such as meeting policyholder needs; appropriate margins; investment backing; legal, underwriting and taxation considerations; and, where appropriate, currency risks; as well as Liberty's administrative capabilities for managing these products.
- **Underwriting committee** – reviews underwriting standards and claims experience as well as monitoring reinsurance retention limits and stop loss limits.

#### Management of insurance and financial risk on contractual obligations to policyholders

Liberty issues contracts that expose it to insurance risk or financial risk, or in some cases, both of these. Set out below are Liberty's objectives in managing risks from insurance contracts and its policies for mitigating those risks.

#### *The Capital Adequacy Requirement (CAR) as part of the risk management framework*

CAR is intended to approximate a risk-based capital measure. It is calculated based on a number of stress tests, specified in actuarial guidance, PGN 104, which are intended to provide approximately a 95% confidence level that the insurer will be able to meet all obligations over time under a variety of scenarios.

Liberty is in the process of developing economic capital models to better understand its capital requirements and the underlying risks, in order to continually improve the management of these risks.

#### *Market risk*

Liberty is exposed to market risk through its financial assets, financial liabilities (investment contracts and borrowings), and insurance liabilities. In particular, the key financial risk is that the proceeds from its financial assets are not sufficient to fund the obligations arising from its insurance and investment contracts. The most important components of this financial risk are interest rate risk, equity price risk and currency risk. These risks arise from open positions in interest rate, currency and equity products, all of which are exposed to general and specific market movements.

## Risk management and control *continued*

Liberty manages these positions within an asset liability management (ALM) framework that aims to match assets to the liabilities arising from insurance and investment contracts by currency, nature and term. For each distinct category of liabilities in terms of the ALM framework, a separate asset profile is maintained. In some instances, segregated portfolios of assets are held for books of business within these broad categories.

### *Interest rate and equity price risk*

These risks have very different impacts on the various categories of business used in Liberty's ALM framework. Interest rate and equity price risk are discussed together since they interact on certain types of liabilities.

#### (a) Guaranteed maturity values

Embedded derivatives in the form of guaranteed maturity values are attached to a significant portion of unit linked business. Liabilities arising from these embedded derivatives are valued in accordance with valuation techniques described in actuarial guidance PGN 110, issued by the Actuarial Society of South Africa. These liabilities are essentially put options on the underlying unit linked liabilities and as such are sensitive to movements in interest rates and equity prices. Liberty is investigating ways in which this interest rate and equity risk exposure could be more closely hedged than it is at present.

#### (b) Guaranteed annuity options

Guaranteed annuity options (GAOs) give the policyholder the option to convert the maturity proceeds of a retirement annuity into an annuity at a pre-defined rate. GAOs are no longer sold on new business. As in the case of guaranteed maturity values, liabilities arising from these embedded derivatives are valued in accordance with valuation techniques described in PGN 110.

GAOs expose Liberty to significant interest rate risk. Liberty is investigating ways in which interest rate and equity risk exposure on GAOs could be more closely hedged. To some extent the upside equity risk exposure on GAOs can be offset against the downside equity price risk exposure on guaranteed maturity values.

#### (c) Unit linked business

For unit linked contracts, Liberty holds the assets on which the unit prices are based. As a result, there is no mismatch. Gross unit liabilities are however reduced by the present value of future expenses and risk claims less the present value of future charges for purposes of this matching exercise. Some interest rate, equity price, credit and currency risk is consequently retained on this business to the extent that present value of future expenses and risk claims less the present value of future charges do not move in line with gross unit liabilities.

Within this category of business there are insurance contracts with minimum guaranteed death benefits and universal life type contracts in terms of which the sum at risk depends on the fair value of the underlying investments. These contract

features mean that fluctuations in market prices affect Liberty's exposure to mortality risk.

#### (d) Non-participating annuities

Non-participating annuities have benefit payments that are fixed and guaranteed at inception of the contract (although a small proportion of the business provides inflation related increases on annuities in payment). These liabilities are backed largely by fixed income securities, with other assets held only to support the longest dated cashflows arising from a portion of these liabilities. Liberty's primary financial risk on these contracts is the risk that interest income and capital redemptions from the financial assets backing the liabilities is insufficient to fund the guaranteed benefits payable.

Liberty monitors interest rate risk in this business by comparing the modified duration and convexity of the investment portfolio and the liabilities issued.

#### (e) Long-term insurance contracts with discretionary participating features (DPF)

Liberty has a number of books of long-term insurance contracts with DPF, most of which have been acquired from other insurers. Each book of business is backed by a distinct asset profile, often as a result of conditions included in the Scheme of Transfer in terms of which the business was acquired. The assets backing these liabilities are generally segregated from Liberty's other assets to ensure that the assets are used exclusively to provide benefits for the relevant policyholders.

Liberty recognises the full value of the backing assets as a liability. However, Liberty only bears interest rate risk in relation to the guaranteed benefits under these contracts, and not in respect of the DPF component of the liability. Furthermore, Liberty is only exposed to equity price risk on this business to the extent that equities are held to back the guaranteed portion of the liability.

#### (f) Guaranteed capital bonds

Guaranteed capital bonds have benefit payments that are fixed and guaranteed at inception of the contract. The ALM framework dictates that assets are selected to provide a cash flow match to these liabilities. There is consequently very little interest rate risk on these products and no equity price risk. On this business the risk of a change in tax laws is mitigated through policy terms and conditions which enable this risk to be passed back to the policyholder.

### *Currency risk*

Offshore assets are held in policyholder assets to match the corresponding liabilities. As a result, the group is exposed to currency risk through maturity guarantees issued on contracts invested in offshore portfolios. Maturity guarantees are no longer offered on new business invested in offshore portfolios. The rand denominated value of management fees derived from these

contracts is also subject to currency risk. Strengthening of the rand against the offshore currencies reduces the value of management fees and increases the liability in respect of embedded derivatives on this business.

#### *Insurance risk*

Insurance risk is the risk that future claims and expenses will exceed the value placed on insurance liabilities. It occurs due to the uncertainty of the timing and amount of future cash flows arising under insurance contracts. The timing is specifically influenced by future mortality, morbidity, and withdrawal rates about which assumptions are made in order to place a value on the liabilities. Deviations from assumptions will result in actual cash flows differing from those projected in liability calculations. As such, each assumption represents a source of uncertainty.

#### *Policyholder behaviour risk*

Policyholders have the option to discontinue or reduce contributions or withdraw benefits prior to expiry of the contract term. As a result, policyholder behaviour contributes to insurance risk. The main risk posed by this behaviour is the risk that expenses and commissions incurred early in the term of the contract but priced to be recovered by means of ongoing charges over a longer period are not recovered prior to the decision by the policyholder to cease or reduce contributions.

On contracts where a withdrawal benefit is payable, this risk is mitigated by conditions built into policy contracts which enable Liberty to recoup these unrecovered expenses by means of a lump sum charge. However, the Pension Funds Adjudicator has recently challenged the practice of levying charges of this sort on retirement annuity contracts, by issuing a number of determinations against life insurers, including Liberty. This is symptomatic of growing consumer dissatisfaction with this practice. Charges of this sort will therefore be limited in terms of an industry agreement with National Treasury. This will increase Liberty's exposure to the risks associated with policyholder behaviour.

#### *Mortality and morbidity risk*

Procedures to control and manage the underwriting risks at a Liberty level are in operation, of which the more significant are discussed below.

The statutory actuary reports annually on the actuarial soundness of the premium rates in use and the profitability of the business, taking into consideration the reasonable benefit expectations of policyholders. All new premium rates are approved and authorised by the statutory actuary prior to being issued. Regular investigations into mortality and morbidity experience are conducted. Catastrophe insurance is in place for single event disasters. Assumptions are made concerning the expected deaths and disabilities (including disease claims) that will occur in each future time period. The significant classes of business most affected by mortality and morbidity risk are:

#### (a) Life annuity business

In terms of life annuity business, the life insurer undertakes to pay a series of future payments contingent on the policyholder's survival. The most significant insurance risk on these liabilities is continued medical advances and improvements in social conditions that will lead to increases in longevity. A proportion of both group and individual disability income business is reinsured on a proportionate quota share basis, so a proportion of all annuities arising from disability income claims are reinsured. No additional reinsurance is purchased in respect of this class of business.

#### (b) Group mortality and morbidity business

The risks for this class of business are very similar to those for individual insurance business. The most important differences result from the greater correlation between individual risks on group schemes because lives assured work in the same location, industry etc. For this reason, Liberty attempts to ensure that a diversified portfolio of schemes is insured.

#### (c) Individual insurance business

Individual insurance contracts are those issued to individuals where death or disability is the insured risk. The most significant factors that could increase the frequency of mortality claims are epidemics, such as AIDS and Asian bird flu, or lifestyle changes such as eating, drinking and exercise habits, resulting in earlier or more claims than expected. The health condition and family medical history of applicants are assessed at inception of new contracts as part of the underwriting process with premiums and terms and conditions being varied accordingly. Special risks, such as hazardous pursuits and unusual medical conditions, are also assessed at underwriting stage. The underwriting committee determines underwriting guidelines concerning authority limits and procedures to be followed.

#### *Credit risk*

Credit risk is the risk that a counterparty to a financial instrument will fail to discharge an obligation and cause Liberty to incur a financial loss.

Provisions of the Long Term Insurance Act 1998 have the effect of limiting exposure to individual issuers due to the inadmissibility of assets for regulatory purposes if specified limits are breached. Credit ratings of reinsurers are taken into account in reinsurance placement decisions. Credit exposure to reinsurers is also limited through the use of a number of reinsurers. Scrip lending counterparties are restricted to appropriately accredited institutions.

Liberty has no significant concentration of credit risk in terms of insurance and other receivables due to the relative significance of the total value and the wide spread of individual debtors. Derivative counterparties and cash transactions are limited to high credit quality financial institutions. Liberty has policies that limit the amount of the credit exposure to any one financial institution.

## Risk management and control *continued*

Liberty is exposed to tenant default within its investment property portfolio. This exposure risk is mainly attributable to policyholders and the shareholder exposure is limited to management fees and profit margins. The managed diversity of the property portfolio and the existence of multi-tenanted buildings significantly reduces exposure to this credit risk.

### *Liquidity risk*

Net cash flows are closely monitored. Over the last few years Liberty has experienced positive net cash flows. In addition, Liberty has significant credit lines over and above the liquid assets held to meet cash demands.

Liquidity requirements and cash resources are monitored on a monthly basis by the capital management committee.

### *Embedded derivatives not valued at fair value*

Guaranteed maturity values, guaranteed annuity options and a return of contributions on death are features of insurance contracts written by Liberty. These are valued in accordance with PGN 110.

### Taxation risk

Taxation risk is the risk that the group will incur a financial loss due to an incorrect interpretation and application of taxation legislation or due to the impact of new taxation legislation on existing business.

During the development stage of any new product and prior to any corporate transactions the taxation resources of the group, and if required external resources, identify and advise on any potentially material taxation impact.

Proposed new taxation legislation is researched fully by the legal and taxation resources to identify any potential impact to the group and where appropriate representation is made to the relevant government minister, including lobby groups, to assist in ensuring the fairness of new taxation legislation.

Taxation risk is further mitigated through contract and policy terms and conditions which, in most instances, enable the risk to be passed back to the customer.

### Group audit assurance

The group internal audit function operates under a mandate from the group audit committee and has the authority to determine the scope and extent of work to be performed. Group internal audit's primary objective is the provision of assurance to the group audit committee. It assists the executive management team in meeting their business objectives by examining the group's activities, assessing the risks involved, and evaluating the adequacy and effectiveness of processes, systems and controls to manage these risks. A risk-based audit approach has been adopted. Material or significant control weaknesses and planned management remedial actions are reported to the group audit committee and to subsidiary audit committees. These issues are tracked to ensure that agreed remedial actions have been implemented. Overdue issues are reported to the group audit committee on a quarterly basis.

## Risk management focus for 2006

The group is currently in the process of quantifying its level of risk appetite and risk tolerance which will take into account:

- the level of earnings volatility it is prepared to accept around its budgeted earnings; and
- the risk profile it is going to tolerate to generate the expected earnings.

In this context, risk profile is the allocation of risk appetite across the various risk categories (e.g. market risk, credit risk, operational risk).

The process to determine both "risk appetite" and "risk tolerance" takes external and internal inputs into account, including:

#### External

- shareholder expectations;
- rating considerations;
- regulatory constraints;
- securities market data;

- analyst views;
- providers of funding/liquidity; and
- economic environment.

#### Internal

- group and business area objectives and strategic plans;
- growth targets; and
- capital management.

The amount of risk the group is prepared to accept will be linked to its financial and strategic objectives as detailed in its overall business plan and budget. Specifically, there needs to be congruency between:

- budgeted earnings (which take account of maturation effects and forecast changes in the economic environment);
- earnings volatility around the budget;
- risk limits; and
- capital.