Mercantile Bank
Limited

Registration number 1965/006706/06
An authorised Financial Services
and Credit Provider NCRCP19
Member of CGD Group

2012 Audited Annual Financial Statements

your bank, your partner, our focus

Mercantile Bank Limited

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

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

Glossary of terms

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

Directors' responsibility

In terms of the Companies Act, the Directors are required to maintain adequate accounting records and prepare annual financial statements that fairly present the financial position at year-end and the results and cash flows for the year ended 31 December 2012 of the Company.

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

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

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

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

These annual financial statements, set out on pages 5 to 54, have been approved by the Board and are signed on their behalf by:

J A S de Andrade Campos
Chairman

26 March 2013

D J Brown
Chief Executive Officer

26 March 2013

Certificate from the Company Secretary

In terms of the provisions of the Companies Act, I certify that, to the best of my knowledge and belief, the Company has lodged with the Registrar of Companies for the financial year ended 31 December 2012, all such returns as are required of a public company in terms of the Companies Act, and that all such returns are true, correct and up to date.

F J Schutte
Acting Company Secretary

26 March 2013

Independent auditor's report

to the shareholder of Mercantile Bank Limited

Report on the financial statements

We have audited the annual financial statements of the Company, which comprise the statement of financial position as at 31 December 2012, the statement of comprehensive income, the statement of changes in equity and the statement of cash flows for the year then ended, a summary of significant accounting policies and other explanatory information as set out on pages 7 to 54.

Directors' responsibility for the financial statements

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

Auditor's responsibility

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

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

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

Opinion

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at 31 December 2012, and of its financial performance and its cash flows for the year then ended in accordance with IFRS and the requirements of the Companies Act of South Africa.

Other reports required by the Companies Act

As part of our audit of the financial statements for the year ended 31 December 2012, we have read the Audit Committee report and the Directors' report for the purpose of identifying whether there are material inconsistencies between the reports and the audited financial statements. The reports are the responsibility of the respective preparers. Based on reading the reports, we have not identified material inconsistencies between the reports and the audited financial statements. However, we have not audited the reports and accordingly do not express an opinion on the reports.

Deloitte & Touche
Registered Auditors

Per **Danie Crowther**
Partner

26 March 2013

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

National Executive: LL BAM Chief Executive, AE Swiegers Chief Operating Officer, GM Pinnock Audit, DL Kennedy Risk Advisory & Legal Services, NB Kader Tax, TP Pillay Consulting, K Black Clients & Industries, JK Mazzocco Talent & Transformation, CR Beukman Finance, M Jordan Strategy, S Gwala Special Projects, TJ Brown Chairman of the Board, MJ Comber Deputy Chairman of the Board

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

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

Member of Deloitte Touche Tohmatsu Limited

Audit Committee report

for the year ended 31 December 2012

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

Terms of reference

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

Composition

The AC comprises four independent Non-Executive Directors. At 31 December 2012 the members were:

L Hyne (Chairman) CA(SA)
GP de Kock
TH Njikizana CA(SA)
D Naidoo CA(SA)

The Chief Executive Officer; Deputy Chief Executive Officer; Executive Director; head of Finance; head of Risk; representatives from the External and Internal Auditors; and the head of Compliance, attend the committee meetings by invitation. The External and Internal Auditors have unrestricted access to the AC Chairman or any other member of the Committee, as required.

Meetings

The AC held five meetings during the period under review. During their tenure as members of the Committee, all members attended each of these meetings.

Statutory duties

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

- nominated for appointment as auditor, Deloitte & Touche which, in its opinion, is independent of the Company;
- determined the fees to be paid to Deloitte & Touche as disclosed in note 25 to the annual financial statements;
- determined Deloitte & Touche's terms of engagement;
- believes the appointment of Deloitte & Touche complies with the relevant provisions of the Companies Act and King III;
- pre-approved all non-audit service contracts with Deloitte & Touche in accordance with its policy;
- received no complaints with regard to accounting practices and the internal audit of the Company, the content or auditing of its financial statements, the internal financial controls of the Company, and any other related matters; and
- advised the Board that regarding matters concerning the Company's accounting policies, financial control, records and reporting, it concurs that the adoption of the going concern premise in the preparation of the financial statements is appropriate.

Internal financial control and internal audit

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

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

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

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

Regulatory compliance

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

External audit

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

Based on our satisfaction with the results of the activities outlined above, the AC has recommended to the Board that Deloitte & Touche should be reappointed for 2013.

Finance function

The AC believes that Mr K R Kumbier, the Deputy Chief Executive Officer, who was responsible for Finance for the duration of 2012 up to the date of this report, possessed the appropriate expertise and experience to meet his responsibilities in that position. We are also satisfied with the expertise and adequacy of resources within the finance function.

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

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

Financial statements

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

On behalf of the AC

L Hyne
Chairman of the AC

26 March 2013

Directors' report

for the year ended 31 December 2012

The Directors have pleasure in presenting their report, which forms part of the audited annual financial statements of the Company for the year ended 31 December 2012.

1. Nature of business

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

2. Holding company

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

3. Financial results

Details of the financial results are set out on pages 7 to 54 and in the opinion of the Directors, require no further comment.

4. Share capital

There were no changes to the authorised and issued share capital of the Company during the year (2011: nil). The authorised and issued share capital of the Company is detailed in note 14 to the annual financial statements.

5. Dividends

A dividend in specie of R117.683 million (2011: nil) was declared on 25 July 2012 following the share buy-back transaction by MBHL of its minority shareholders.

A dividend of R29.672 million was declared on 20 February 2013 in respect of the year ended 31 December 2012 (2011: R59.929 million).

6. Directors, Company Secretary and registered addresses

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

J A S de Andrade Campos *+	(Chairman)
D J Brown #	(Chief Executive Officer)
G P de Kock °	
L Hyne °	
A T Ikalafeng °	
K R Kumbier #	
J P M Lopes *#	
T H Njikizana ^°	
D Naidoo (appointed 23 May 2012) °	

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

A de Villiers resigned as Company Secretary on 30 June 2012, and her successor, M Naidoo, appointed on 1 July 2012, resigned on 5 December 2012. F J Schutte was appointed as Acting Company Secretary with effect from 6 December 2012.

Postal:	**Physical:**
PO Box 782699	1st Floor
Sandton	Mercantile Bank
2146	142 West Street
	Sandown
	2196

7. Going concern

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

8. Special resolutions

On 6 February 2012, the issue of a suretyship limited to an amount of R48.9 million, in favour of Standard Bank Limited for a loan granted to Portion 2 of Lot 8 Sandown (Pty) Ltd, was approved.

On 22 April 2012, to amend the Company's Memorandum of Incorporation (previously the Articles of Association) by inserting Article 23A.

9. Events after the reporting period

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

Accounting policies

for the year ended 31 December 2012

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

1. Basis of presentation

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

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

2. Recognition of assets and liabilities

2.1 Assets

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

2.2 Liabilities

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

2.3 Provisions

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

2.4 Contingent liabilities

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

3. Financial instruments

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

The Company de-recognises a financial asset when:

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

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

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

3.1 Derivative financial instruments

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

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

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

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

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

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

3.2 Financial assets

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

Accounting policies

for the year ended 31 December 2012 (continued)

3. Financial instruments (continued)

3.2 Financial assets (continued)

Financial assets at fair value through profit and loss

Financial assets are designated at fair value through profit and loss primarily to eliminate or significantly reduce the accounting mismatch. The Company seeks to demonstrate that by applying the fair value option, which measures fair value gains and losses in profit and loss, it significantly reduces measurement inconsistency that would otherwise arise from measuring derivatives and such designated financial assets, at amortised cost.

Available-for-sale financial assets

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

Cash and cash equivalents

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

Bank term deposits

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

Other investments

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

Negotiable securities

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

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

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

Loans and advances

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

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

Other accounts receivable

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

3.3 Financial liabilities

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

3.4 Fair value estimation

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

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

Accounting policies

for the year ended 31 December 2012 (continued)

3. Financial instruments (continued)

3.5 Amortised cost

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

3.6 Impairments

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

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

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

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

Where the impairment loss subsequently reverses, the carrying amount of the advance is increased to the revised estimate of its recoverable amount, subject to the increased carrying amount not exceeding the carrying amount that would have been determined had no impairment loss been recognised for the advance in prior years. A reversal of an impairment loss is recognised in profit and loss immediately, except for the reversal of an impairment of equity instruments designated as available-for-sale, which is recognised in other comprehensive income.

4. Foreign currency transactions

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

5. Subsidiaries

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

6. Associated companies

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

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

7. Property and equipment

7.1 Owner-occupied properties

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

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

Accounting policies

for the year ended 31 December 2012 (continued)

7. Property and equipment (continued)

7.2 Equipment

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

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

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

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

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

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

8. Intangible assets

Computer software

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

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

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

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

9. Non-current assets held for sale

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

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

10. Tax

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

10.1 Current tax

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

Accounting policies

for the year ended 31 December 2012 (continued)

10. Tax (continued)

10.2 Deferred tax

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

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

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

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

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

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

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

10.3 Current and deferred tax for the period

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

11. Instalment sales and leases

11.1 The Company as the lessee

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

11.2 The Company as the lessor

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

12. Interest income and interest expense

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

13. Fee, commission and dividend income

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

14. Retirement funds

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

Accounting policies

for the year ended 31 December 2012 (continued)

15. Post-retirement medical benefits

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

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

16. Share-based payment arrangements

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

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

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

17. Critical accounting estimates and judgements

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

17.1 Impairment losses on loans and advances

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

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

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

17.2 Fair value of financial instruments

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

17.3 Impairment of available-for-sale equity investments

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

Accounting policies

for the year ended 31 December 2012 (continued)

17. Critical accounting estimates and judgements (continued)

17.4 Income taxes

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

18. Recent accounting developments

There are new and revised standards and interpretations in issue that are not yet effective and there are no plans to early adopt. These include the following standards and interpretations that could be applicable to the business of the Company and may have an impact on future financial statements. The impact of initial application of the following standards has not been assessed as at the date of authorisation of the annual financial statements and will be applied for years ending after 31 December 2012:

	Standard	Effective date
IFRS 1	First-time adoption of IFRS: Amendments resulting from annual improvements 2009-2011 cycle	Annual periods beginning on or after 1 January 2013
IFRS 7	Financial Instruments: Amendments enhancing disclosures about offsetting of financial assets and financial liabilities	Annual periods beginning 1 January 2013 and interim periods within those periods
IFRS 7	Financial Instruments: Amendments requiring disclosures about the initial application of IFRS 9	Annual periods beginning on or after 1 January 2015 (or otherwise when IFRS 9 is first applied)
IFRS 9	Financial Instruments: Classification and measurement	Annual periods beginning on or after 1 January 2015
IFRS 10	Consolidated financial statements	Annual periods beginning on or after 1 January 2013
IFRS 10	Consolidated financial statements: Amendments for investment entities	Annual periods beginning on or after 1 January 2014
IFRS 11	Joint arrangements	Annual periods beginning on or after 1 January 2013
IFRS 12	Disclosure of interest in other entities	Annual periods beginning on or after 1 January 2013
IFRS 12	Disclosure of interest in other entities: Amendments for investment entities	Annual periods beginning on or after 1 January 2014
IFRS 13	Fair value measurement	Annual periods beginning on or after 1 January 2013
IAS 1	Presentation of financial statements: Amendments to revise the way other comprehensive income is presented	Annual periods beginning on or after 1 July 2012
IAS 1	Presentation of financial statements: Amendments resulting from annual improvements 2009-2011 cycle	Annual periods beginning on or after 1 January 2013
IAS 16	Property, Plant and Equipment: Amendments resulting from annual improvements 2009-2011 cycle	Annual periods beginning on or after 1 January 2013
IAS 19	Employee benefits – Amended standard resulting from the post-employment benefits and termination benefits projects	Annual periods beginning on or after 1 January 2013
IAS 27	Consolidated and separate financial statements: Reissued as IAS 27 Separate financial statements	Annual periods beginning on or after 1 January 2013
IAS 27	Consolidated and separate financial statements: Amendments for investment entities	Annual periods beginning on or after 1 January 2014
IAS 28	Investments in associates: Reissued as IAS 28 Investments in associated and joint ventures	Annual periods beginning on or after 1 January 2013
IAS 32	Financial instruments: Presentation: Amendments resulting from annual improvements 2009-2011 cycle	Annual periods beginning on or after 1 January 2013
IAS 32	Financial instruments: Presentation: Application guidance amendments relating to the offsetting of financial assets and financial liabilities	Annual periods beginning on or after 1 January 2014

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

	Standard/Interpretation	Effective date
IFRS 1	First-time adoption of IFRS: Government loans	Annual periods beginning on or after 1 January 2013
IAS 34	Interim reporting: Amendments resulting from annual improvements 2009-2011 cycle	Annual periods beginning on or after 1 January 2013
IFRIC 20	Stripping costs in the production phase of a surface mine	Annual periods beginning on or after 1 January 2013

Statement of financial position

at 31 December 2012

	Note	2012 R'000	2011 R'000
ASSETS			
Intangible assets	2	**197 823**	206 817
Property and equipment	3	**19 069**	20 002
Tax	4	**1 262**	–
Other accounts receivable	5	**61 447**	69 577
Interest in subsidiaries	6	**118 298**	204 240
Other investments	7	**19 822**	69 162
Deferred tax	8	**–**	16 935
Non-current assets held for sale	9	**13 453**	–
Loans and advances	10	**5 168 753**	4 358 484
Derivative financial instruments	11	**6 565**	15 657
Negotiable securities	12	**257 514**	192 588
Cash and cash equivalents	13	**1 218 714**	936 911
Total assets		**7 082 720**	6 090 373
EQUITY AND LIABILITIES			
Shareholders' equity		**1 685 877**	1 649 695
Share capital and share premium	14	**1 483 300**	1 483 300
General reserve		**12 231**	12 231
Property revaluation reserve		**69**	69
Available-for-sale reserve		**37 855**	22 905
Retained earnings		**152 422**	131 190
Liabilities		**5 396 843**	4 440 678
Deferred tax	8	**30 009**	–
Long-term funding	15	**491 876**	–
Deposits	16	**4 738 236**	4 272 970
Derivative financial instruments	11	**7 160**	17 130
Provisions and other liabilities	17	**70 654**	48 703
Other accounts payable	19	**58 908**	101 875
Total equity and liabilities		**7 082 720**	6 090 373

Statement of comprehensive income

for the year ended 31 December 2012

	Note	2012 R'000	2011 R'000
Interest income	21	**511 076**	445 996
Interest expense	22	**(204 593)**	(181 598)
Net interest income		**306 483**	264 398
Net charge for credit losses	10.4	**(27 992)**	(10 221)
Net interest income after credit losses		**278 491**	254 177
Net gain on disposal of designated through profit and loss investments		**26 555**	–
Net gain on disposal of available-for-sale-investments		**14 555**	–
Gains on remeasurement to fair value on unlisted investments	7	**–**	39 849
Net non-interest income		**205 085**	243 474
Non-interest income	23	**332 160**	307 619
Fee and commission expenditure	24	**(127 075)**	(124 145)
Dividends received from subsidiary	28.2	**–**	60 000
Net interest and non-interest income		**524 686**	537 500
Operating expenditure	25	**(339 586)**	(314 474)
Profit before tax		**185 100**	223 026
Tax	26	**(46 185)**	(42 676)
Profit after tax		**138 915**	180 350
Other comprehensive income/(loss)			
Gains/(Losses) on remeasurement to fair value		**30 668**	(36 489)
Release to profit and loss on disposal of available-for-sale financial assets		**(14 555)**	–
Tax relating to other comprehensive income/loss		**(1 163)**	2 063
Other comprehensive income/(loss) net of tax		**14 950**	(34 426)
Total comprehensive income		**153 865**	145 924
Profit after tax attributable to:			
Total comprehensive income		**153 865**	145 924
Profit after tax attributable to:			
Equity holder of the Company		**138 915**	180 350
Total comprehensive income attributable to:			
Equity holder of the Company		**153 865**	145 924

Statement of changes in equity

for the year ended 31 December 2012

	Share capital R'000	Share premium R'000	Share-based payments reserve R'000	General reserve R'000	Property revaluation reserve R'000	Available-for-sale reserve R'000	Retained earnings R'000	Total R'000
Shareholders' equity at 31 December 2010	124 969	1 358 331	3 190	12 231	69	57 331	10 660	1 566 781
Net movement for the year	–	–	(3 190)	–	–	(34 426)	120 530	82 914
Total comprehensive income for the year	–	–	–	–	–	(34 426)	180 350	145 924
Profit after tax	–	–	–	–	–	–	180 350	180 350
Other comprehensive (loss)	–	–	–	–	–	(36 489)	–	(36 489)
Tax relating to other comprehensive loss	–	–	–	–	–	2 063	–	2 063
Vesting of shares in the conditional share plan	–	–	(1 544)	–	–	–	–	(1 544)
Conversion of conditional share plan	–	–	(1 646)	–	–	–	–	(1 646)
Share-based payments expense	–	–	–	–	–	–	109	109
Dividend paid	–	–	–	–	–	–	(59 929)	(59 929)
Shareholders' equity at 31 December 2011	**124 969**	**1 358 331**	**–**	**12 231**	**69**	**22 905**	**131 190**	**1 649 695**
Net movement for the year	**–**	**–**	**–**	**–**	**–**	**14 950**	**21 232**	**153 865**
Total comprehensive income for the year	**–**	**–**	**–**	**–**	**–**	**14 950**	**138 915**	**153 865**
Profit after tax	**–**	**–**	**–**	**–**	**–**	**–**	**138 915**	**138 915**
Other comprehensive income	**–**	**–**	**–**	**–**	**–**	**16 113**	**–**	**16 113**
Tax relating to other comprehensive income	**–**	**–**	**–**	**–**	**–**	**(1 163)**	**–**	**(1 163)**
Dividend paid (in specie)	**–**	**–**	**–**	**–**	**–**	**–**	**(117 683)**	**(117 683)**
Shareholders' equity at 31 December 2012	**124 969**	**1 358 331**	**–**	**12 231**	**69**	**37 855**	**152 422**	**1 685 877**

Statement of cash flows

for the year ended 31 December 2012

	Note	2012 R'000	2011 R'000
Cash flows from operating activities			
Cash receipts from customers	27.1	**868 539**	759 723
Cash paid to customers, suppliers and employees	27.2	**(610 078)**	(569 701)
Cash generated from operations	27.3	**258 461**	190 022
Dividends received		**434**	60 364
Tax (paid)	27.4	**(1 666)**	–
Net (increase) in income-earning assets	27.5	**(859 796)**	(573 614)
Net increase/(decrease) in deposits and other accounts	27.6	**430 429**	(270 343)
Net cash (outflow) from operating activities		**(172 138)**	(593 571)
Cash flows from investing activities			
Purchase of intangible assets	2	**(15 869)**	(8 501)
Purchase of property and equipment	3	**(9 565)**	(1 222)
Acquisition of non-current assets held for sale		**(13 453)**	–
Dividends paid		**(117 683)**	(59 929)
Proceeds on disposal of investments		**14 555**	189
Decrease/(Increase) in interest in subsidiaries		**104 080**	(159 952)
Net cash (outflow) from investing activities		**(37 935)**	(229 415)
Cash flows from financing activities			
Increase in long-term funding	15	**491 876**	–
Net cash Inflow from financing activities		**491 876**	–
Net cash inflow/(outflow) for the year		**281 803**	(822 986)
Cash and cash equivalents at the beginning of the year		**936 911**	1 759 897
Cash and cash equivalents at the end of year	13	**1 218 714**	936 911

Notes to the annual financial statements

for the year ended 31 December 2012

1. Categories and fair values of financial instruments

1.1 Categories analysis of financial instruments

	2012		2011	
	Fair value R'000	**Carrying amount R'000**	Fair value R'000	Carrying amount R'000
Assets				
Available-for-sale	**156 760**	**156 760**	252 427	252 427
Other investments	**19 822**	**19 822**	29 313	29 313
Interest in subsidiaries	**118 298**	**118 298**	204 240	204 240
Negotiable securities – Government stock	**18 640**	**18 640**	18 874	18 874
Loans and receivables	**6 656 309**	**6 656 699**	5 481 399	5 482 901
Loans and advances				
Current accounts	**1 313 069**	**1 313 069**	963 370	963 370
Credit cards	**17 607**	**17 607**	15 352	15 352
Mortgage loans	**2 395 456**	**2 395 456**	2 006 772	2 006 772
Instalment sales and leases	**276 567**	**276 567**	298 240	298 240
Structured loans	**35 228**	**35 228**	94 037	94 037
Medium-term loans	**1 099 737**	**1 099 737**	924 928	924 928
Negotiable securities				
Treasury bills	**238 484**	**238 874**	172 212	173 714
Cash and cash equivalents	**1 218 714**	**1 218 714**	936 911	936 911
Other accounts receivable	**61 447**	**61 447**	69 577	69 577
Designated at fair value through profit and loss	**31 089**	**31 089**	95 634	95 634
Loans and advances				
Mortgage loans	**29 810**	**29 810**	34 749	34 749
Medium-term loans	**1 279**	**1 279**	21 036	21 036
Other investments	**–**	**–**	39 849	39 849
Held-for-trading				
Derivative financial instruments	**6 565**	**6 565**	15 657	15 657
	6 850 723	**6 851 113**	5 845 117	5 846 619
Liabilities				
Held-for-trading				
Derivative financial instruments	**7 160**	**7 160**	17 130	17 130
Amortised cost	**5 289 020**	**5 289 020**	4 374 845	4 374 845
Long-term funding	**491 876**	**491 876**	–	–
Deposits	**4 738 236**	**4 738 236**	4 272 970	4 272 970
Other accounts payable	**58 908**	**58 908**	101 875	101 875
	5 296 180	**5 296 180**	4 391 975	4 391 975

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

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

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

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

1.3 Fair value measurements recognised in the statement of financial position

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

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

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

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

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

	Level 1 R'000	Level 2 R'000	Level 3 R'000	Total R'000
2012				
Assets				
Available-for-sale				
Other investments	**14 831**	–	**4 991**	**19 822**
Interest in subsidiaries	–	**118 298**	–	**118 298**
Negotiable securities – Government stock	**18 640**	–	–	**18 640**
Designated at fair value through profit and loss				
Loans and Advances				–
Mortgage loans	–	**29 810**	–	**29 810**
Medium-term loans	–	**1 279**	–	**1 279**
Other investments	–	–	–	–
Held-for-trading				
Derivative financial instruments	**6 565**	–	–	**6 565**
	40 036	**149 387**	**4 991**	**194 414**
Liabilities				
Held-for-trading				
Derivative financial instruments	**7 160**	–	–	**7 160**
	7 160	–	–	**7 160**
2011				
Assets				
Available-for-sale				
Other investments	24 923	–	4 390	29 313
Interest in subsidiaries	–	204 240	–	204 240
Negotiable securities – Government stock	18 874	–	–	18 874
Designated at fair value through profit and loss				
Loans and Advances				
Mortgage loans	–	34 749	–	34 749
Medium-term loans	–	21 036	–	21 036
Other investments	–	–	39 849	39 849
Held-for-trading				
Derivative financial instruments	15 657	–	–	15 657
	59 454	260 025	44 239	363 718
Liabilities				
Held-for-trading				
Derivative financial instruments	17 130	–	–	17 130
	17 130	–	–	17 130

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

Two Level 3 investments were disposed of during 2012.

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
1. Categories and fair values of financial instruments (continued)		
1.4 Reconciliation of Level 3 fair value measurements of financial assets		
Available-for-sale		
Other investments – unlisted equities		
Balance at the beginning of the year	**4 390**	–
Transfer from Level 2	**–**	216
Gains on remeasurement to fair value in comprehensive income	**601**	4 174
Balance at the end of the year	**4 991**	4 390
Designated at fair value through profit and loss		
Other investments – unlisted equities		
Balance at the beginning of the year	**39 849**	–
Gains on remeasurement to fair value in comprehensive income	**–**	39 849
Realisation	**(39 849)**	–
Balance at the end of the year	**–**	39 849

	2012 R'000	2011 R'000
2. Intangible assets		
Computer software		
Cost at the beginning of the year	**302 173**	296 926
Additions	**15 869**	8 501
Net transfer from property and equipment*	**–**	487
Write-off of obsolete software	**(86)**	(3 741)
Cost at the end of the year	**317 956**	302 173
Accumulated amortisation and impairment losses at the beginning of the year	**(95 356)**	(72 524)
Amortisation	**(24 863)**	(25 740)
Write-off of obsolete software	**86**	2 908
Accumulated amortisation and impairment losses at the end of the year	**(120 133)**	(95 356)
Net carrying amount at the end of the year	**197 823**	206 817

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

During 2011 and 2012, the Bank identified no events or circumstances that would indicate that the Banks's intangible assets may need to be impaired.

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

3. Property and equipment

	Owner-occupied property R'000	Leasehold improvements R'000	Computer equipment R'000	Furniture and fittings R'000	Office equipment R'000	Motor vehicles R'000	Total R'000
2012							
Open market value/cost at the beginning of the year	164	19 570	87 629	9 978	29 497	467	147 305
Additions	–	–	5 551	17	3 997	–	9 565
Disposals	–	–	–	–	–	(29)	(29)
Write-off of obsolete assets	–	(1 061)	(1 359)	(158)	(5 048)	–	(7 626)
Open market value/cost at the end of the year	164	18 509	91 821	9 837	28 446	438	149 215
Accumulated depreciation and impairment losses at the beginning of the year	–	(16 822)	(77 593)	(9 478)	(22 964)	(446)	(127 303)
Depreciation	–	(670)	(6 261)	(126)	(2 545)	(19)	(9 621)
Disposals	–	–	–	–	–	29	29
Write-off of obsolete assets	–	1 061	1 359	158	4 171	–	6 749
Accumulated depreciation and impairment losses at the end of the year	–	(16 431)	(82 495)	(9 446)	(21 338)	(436)	(130 146)
Net carrying amount at the end of the year	164	2 078	9 326	391	7 108	2	19 069
2011							
Open market value/cost at the beginning of the year	164	19 570	93 980	9 902	26 191	492	150 299
Additions	–	–	279	66	877	–	1 222
Transfer*	–	–	(2 926)	10	2 429	–	(487)
Write-off of obsolete assets	–	–	(3 704)	–	–	(25)	(3 729)
Open market value/cost at the end of the year	164	19 570	87 629	9 978	29 497	467	147 305
Accumulated depreciation and impairment losses at the beginning of the year	–	(16 138)	(75 542)	(9 338)	(21 335)	(438)	(122 791)
Depreciation	–	(684)	(5 755)	(130)	(1 639)	(33)	(8 241)
Transfer*	–	–	–	(10)	10	–	–
Write-off of obsolete assets	–	–	3 704	–	–	25	3 729
Accumulated depreciation and impairment losses at the end of the year	–	(16 822)	(77 593)	(9 478)	(22 964)	(446)	(127 303)
Net carrying amount at the end of the year	164	2 748	10 036	500	6 533	21	20 002

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

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

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

		2012 R'000	2011 R'000
4.	**Tax**		
	South African Revenue Services		
	Tax overpaid	**1 262**	–
		1 262	–
5.	**Other accounts receivable**		
	Items in transit	**24 660**	20 757
	Loan to subsidiary (refer to note 28.2)	**25**	48
	Prepayments and deposits	**9 273**	5 106
	Other receivables	**27 489**	43 666
		61 447	69 577
6.	**Interest in subsidiaries**		
	Unlisted		
	Shares at fair value		
	Portion 2 of Lot 8 Sandown (Pty) Ltd	**23 002**	6 933
	Loans to/(from) subsidiaries	**95 296**	197 307
	Portion 2 of Lot 8 Sandown (Pty) Ltd	**(7 128)**	87 205
	LSM (Troyeville) Properties (Pty) Ltd	**7 618**	7 352
	Custom Capital (Pty) Ltd	**96 291**	106 305
	Less: Provisions held against loan accounts	**(1 485)**	(3 555)
		118 298	204 240

A register containing details of investments in subsidiaries is available for inspection at the registered office of the Company.

The loans to/(from) Portion 2 of Lot 8 Sandown (Pty) Ltd and LSM (Troyeville) Properties (Pty) Ltd bear interest at the prevailing prime rate plus 2% (2011: prime rate plus 2%) and have no fixed terms of maturity.

The loan to Custom Capital (Pty) Ltd bears interest at the prevailing repo rate (2011: repo rate) and has no fixed terms of maturity.

		2012 R'000	2011 R'000
7.	**Other investments**		
	Available-for-sale		
	Unlisted equities	**4 991**	4 390
	Listed equities	**14 831**	24 923
	Mercantile Bank Holdings Limited (shares held by the Bank for the employee share option scheme)	–	6 011
	Visa Inc.*	**14 831**	18 912
	Designated at fair value through profit and loss		
	Unlisted equities	–	39 849
		19 822	69 162

Of the shareholding in Visa Inc., 50% was sold during 2012.

A register containing details of other investments is available for inspection at the registered office of the Company.

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
8. Deferred tax		
Balance at the beginning of the year	**16 935**	57 548
Current year charge		
Per the statement of comprehensive income	**(45 781)**	(42 676)
Per the statement of changes in equity/other comprehensive income	**(1 163)**	2 063
	(30 009)	16 935
Comprising		
Deferred tax assets	**–**	16 935
Deferred tax liabilities	**(30 009)**	–
	(30 009)	16 935
Deferred tax is attributable to the following temporary differences		
Intangible assets	**(47 273)**	(37 621)
Provisions and other liabilities	**(5 482)**	(10 537)
Calculated tax losses	**–**	44 883
Leases	**2 622**	2 120
Revaluations	**(4 966)**	(3 803)
Interest rate swaps	**411**	666
Current assets	**24 679**	21 227
	(30 009)	16 935

Deferred tax assets have been recognised for the carry forward amount of unused tax losses relating to the Company's operations where, inter alia, tax losses can be carried forward and there is evidence that it is probable that sufficient taxable profits will be available in the future to utilise all tax losses carried forward.

	2012 R'000	2011 R'000
9. Non-current assets held for sale		
Properties in possession	**13 453**	–
	13 453	–

The Bank intends to dispose of a property that was purchased as a result of a loan default, within the next 12 months. The property has been valued based on an independent valuation obtained and allowing for cost of disposal.

	2012 R'000	2011 R'000
10. Loans and advances		
10.1 Product analysis		
Amortised cost	**5 241 859**	4 379 212
Current accounts	**1 340 870**	983 266
Credit cards	**22 227**	19 777
Mortgage loans	**2 433 471**	2 018 908
Instalment sales and leases	**285 334**	307 770
Structured loans	**44 579**	103 081
Medium-term loans	**1 115 378**	946 410
Fair value through profit and loss	**2 145**	55 822
Mortgage loans	**2 011**	34 754
Medium-term loans	**134**	21 068
Gross loans and advances	**5 244 004**	4 435 034
Less: Portfolio impairments for credit losses	**(12 320)**	(4 399)
Specific impairments for credit losses	**(62 931)**	(72 151)
	5 168 753	4 358 484

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

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
10. Loans and advances (continued)		
10.2 Maturity analysis		
Repayable on demand and maturing within one month	**1 388 731**	1 165 691
Maturing after one month but within six months	**10 186**	19 623
Maturing after six months but within 12 months	**405 473**	71 295
Maturing after 12 months	**3 439 614**	3 178 425
	5 244 004	4 435 034

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

10.3 Detailed product analysis of loans and advances

	Gross amount R'000	Portfolio impairments R'000	Specific impairments R'000	Net balance R'000
2012				
Current accounts	**1 340 870**	**5 067**	**22 734**	**1 313 069**
Credit cards	**22 227**	**1 282**	**3 338**	**17 607**
Mortgage loans	**2 435 482**	**1 212**	**9 004**	**2 425 266**
Instalment sales and leases	**285 334**	**495**	**8 272**	**276 567**
Structured loans	**44 579**	**403**	**8 948**	**35 228**
Medium-term loans	**1 115 512**	**3 861**	**10 635**	**1 101 016**
	5 244 004	**12 320**	**62 931**	**5 168 753**
2011				
Current accounts	983 266	1 144	18 752	963 370
Credit cards	19 777	811	3 614	15 352
Mortgage loans	2 053 662	309	11 832	2 041 521
Instalment sales and leases	307 770	592	8 938	298 240
Structured loans	103 081	62	8 982	94 037
Medium-term loans	967 478	1 481	20 033	945 964
	4 435 034	4 399	72 151	4 358 484

10.4 Impairments for credit losses

	Total R'000	Current accounts R'000	Credit cards R'000	Mortgage loans R'000	Instalment sales and leases R'000	Structured loans R'000	Medium-term loans R'000
2012							
Balance at the beginning of the year	**76 550**	**19 896**	**4 425**	**12 141**	**9 530**	**9 044**	**21 514**
Movements for the year:							
Credit losses written off	**(24 287)**	**(1 001)**	**(650)**	**(339)**	**(848)**	**(11 000)**	**(10 449)**
Net impairments raised/(released)	**22 988**	**8 906**	**845**	**(1 586)**	**85**	**11 307**	**3 431**
Balance at the end of the year	**75 251**	**27 801**	**4 620**	**10 216**	**8 767**	**9 351**	**14 496**
2011							
Balance at the beginning of the year	67 584	15 376	4 719	10 407	4 502	18 991	13 589
Movements for the year:							
Credit losses written off	(1 982)	(705)	(412)	–	(308)	–	(557)
Net impairments raised/(released)	10 948	5 225	118	1 734	5 336	(9 947)	8 482
Balance at the end of the year	76 550	19 896	4 425	12 141	9 530	9 044	21 514

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
10. Loans and advances (continued)		
10.4 Impairments for credit losses (continued)		
Net charge for credit losses in the statement of comprehensive income		
Net impairments raised	**(22 988)**	(10 948)
Amounts directly written off to other comprehensive income	**(5 142)**	–
Recoveries in respect of amounts previously written off	**138**	727
	(27 992)	(10 221)

10.5 Product analysis of performing loans and advances

	Gross amount R'000	Portfolio impairment R'000	Net balance R'000
2012			
Current accounts	**1 301 685**	**5 067**	**1 296 618**
Credit cards	**18 889**	**1 282**	**17 607**
Mortgage loans	**2 360 976**	**1 212**	**2 359 764**
Instalment sales and leases	**276 755**	**495**	**276 260**
Structured loans	**29 447**	**403**	**29 044**
Medium-term loans	**1 084 349**	**3 861**	**1 080 488**
	5 072 101	**12 320**	**5 059 781**
2011			
Current accounts	946 234	1 144	945 090
Credit cards	16 163	811	15 352
Mortgage loans	1 954 391	309	1 954 082
Instalment sales and leases	293 098	592	292 506
Structured loans	87 457	62	87 395
Medium-term loans	924 863	1 481	923 382
	4 222 206	4 399	4 217 807

	2012 R'000	2011 R'000
10. Product analysis of performing loans and advances excluding loans and advances with renegotiated terms		
Current accounts	**1 301 189**	946 234
Credit cards	**18 889**	16 154
Mortgage loans	**2 353 378**	1 942 801
Instalment sales and leases	**276 755**	293 098
Structured loans	**29 447**	87 457
Medium-term loans	**1 080 869**	913 704
	5 060 527	4 199 448
10.7 Product analysis of loans and advances with renegotiated terms that would otherwise be past due or impaired		
Current accounts	**496**	–
Credit cards	**–**	9
Mortgage loans	**7 598**	11 590
Instalment sales and leases	**–**	–
Structured loans	**–**	–
Medium-term loans	**3 480**	11 159
	11 574	22 758

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

10. Loans and advances (continued)

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

	Past due for: 1 – 30 days R'000	31 – 60 days R'000	61 – 90 days R'000	Total gross amount R'000	Fair value of collateral and other credit enhance-ments R'000
2012					
Current accounts	–	–	–	–	–
Credit cards	–	–	–	–	–
Mortgage loans	**24 077**	**8 755**	**54 184**	**87 016**	**78 893**
Instalment sales and leases	**242**	**62**	**115**	**419**	**255**
Structured loans	–	–	–	–	–
Medium-term loans	**5 590**	**5 185**	**7 702**	**18 477**	**7 693**
	29 909	**14 002**	**62 001**	**105 912**	**86 841**
2011					
Current accounts	–	–	–	–	–
Credit cards	–	–	–	–	–
Mortgage loans	23 430	13 012	25 527	61 969	58 645
Instalment sales and leases	95	23	906	1 024	871
Structured loans	–	–	–	–	–
Medium-term loans	5 707	107	9 407	15 221	6 172
	29 232	13 142	35 840	78 214	65 688

10.9 Product analysis of loans and advances that are individually impaired

	Gross amount R'000	Specific impairment R'000	Net balance R'000	Fair value of collateral and other credit enhance-ments R'000
2012				
Current accounts	**39 185**	**22 734**	**16 451**	**11 353**
Credit cards	**3 338**	**3 338**	–	–
Mortgage loans	**74 506**	**9 004**	**65 502**	**66 017**
Instalment sales and leases	**8 579**	**8 272**	**307**	**329**
Structured loans	**15 132**	**8 948**	**6 184**	**6 850**
Medium-term loans	**31 163**	**10 635**	**20 528**	**19 138**
	171 903	**62 931**	**108 972**	**103 687**
2011				
Current accounts	37 032	18 752	18 280	9 507
Credit cards	3 614	3 614	–	–
Mortgage loans	99 271	11 832	87 439	94 359
Instalment sales and leases	14 672	8 938	5 734	5 210
Structured loans	15 624	8 982	6 642	7 782
Medium-term loans	42 615	20 033	22 582	18 730
	212 828	72 151	140 677	135 588

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

10. Loans and advances (continued)

10.10 Collateral held as security and other credit enhancements

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

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

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

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

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

10.11 Structured loans

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

11. Derivative financial instruments

	Notional principal of assets R'000	Fair value of assets R'000	Notional principal of liabilities R'000	Fair value of liabilities R'000
2012				
Held-for-trading				
Foreign exchange contracts	**395 050**	**6 565**	**386 522**	**5 620**
Interest rate swaps	**–**	**–**	**31 237**	**1 540**
	395 050	**6 565**	**417 759**	**7 160**
2011				
Held-for-trading				
Foreign exchange contracts	979 843	15 657	784 018	14 750
Interest rate swaps	–	–	50 573	2 380
	979 843	15 657	834 591	17 130

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
12. Negotiable securities		
Loans and receivables		
Treasury bills	**238 874**	173 714
Available-for-sale		
Government stock	**18 640**	18 874
	257 514	192 588
Maturity analysis		
Maturing within one month	**2 329**	74 643
Maturing after one month but within six months	**125 058**	99 071
Maturing after six months but within 12 months	**111 487**	–
Maturing after one year but within five years	**18 640**	18 874
	257 514	192 588

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

	2012 R'000	2011 R'000
13. Cash and cash equivalents		
Cash on hand	**34 415**	37 338
Central Bank balances	**125 565**	125 632
Money Market funds	**854 068**	51 455
Rand denominated domestic bank balances	**83 966**	87 869
Foreign currency denominated bank balances	**120 700**	634 617
	1 218 714	936 911

	Number of issued ordinary shares	Share capital R'000	Share premium R'000	Total R'000
14. Share capital and share premium				
Opening and closing balance	**62 484 352**	**124 969**	**1 358 331**	**1 483 300**

The total authorised number of ordinary shares is 62 630 000 shares (2011: 62 630 000 shares) with a par value of R2.00 per share.

No shares were issued during the financial years ended 31 December 2012 and 31 December 2011.

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

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
15. Long-term funding		
International Finance Corporation (IFC)	**491 876**	–
	491 876	–

The loan obtained from the IFC in 2011, with interest repayable quarterly and linked to JIBAR, is repayable between 15 September 2014 and 15 September 2018.

	2012 R'000	2011 R'000
16. Deposits		
Call deposits and current accounts	**2 269 800**	2 181 555
Savings accounts	**186 767**	179 708
Term and notice deposits	**2 145 666**	1 750 731
Negotiable certificates of deposit	**29 560**	55 480
Foreign deposits	**106 443**	105 496
	4 738 236	4 272 970
Maturity analysis		
Repayable on demand and maturing within one month	**2 891 750**	2 925 176
Maturing after one month but within six months	**1 280 268**	891 924
Maturing after six months but within 12 months	**528 932**	422 541
Maturing after 12 months	**37 286**	33 329
	4 738 236	4 272 970

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

17. Provisions and other liabilities

	Deferred bonus scheme R'000	Staff incentives R'000	Audit fees R'000	Post-retirement medical benefits R'000	Leave pay R'000	Other risks R'000	Total R'000
At 31 December 2010	–	–	4 610	15 149	9 441	720	29 920
Provision raised	5 793	12 000	6 450	900	167	1 109	26 419
Reversal of provision	–	–	–	–	–	(248)	(248)
Charged to provision	–	–	(7 350)	–	–	(38)	(7 388)
At 31 December 2011	**5 793**	**12 000**	**3 710**	**16 049**	**9 608**	**1 543**	**48 703**
Provision raised	**3 913**	**16 000**	**6 175**	**3 423**	**2 116**	**12 936**	**44 563**
Charged to provision	**(1 677)**	**(12 000)**	**(6 181)**	**–**	**(1 729)**	**(1 025)**	**(22 612)**
At 31 December 2012	**8 029**	**16 000**	**3 704**	**19 472**	**9 995**	**13 454**	**70 654**

Deferred bonus scheme

A cash-settled, conditional phantom share plan was approved by the Board in 2011, in place of the conditional share plan. Awards in terms of the conditional share plan that had not vested as at 30 November 2011, were converted into awards under the conditional phantom share plan (refer to note 29).

Post-retirement medical benefits

Refer to note 18 for detailed disclosure of this provision.

Leave pay

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

Other risks

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

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

18. Post-retirement medical benefits

The Bank operates a partly funded post-retirement medical scheme. The assets of the funded plans are held independently of the Bank's assets in a separate trustee-administered fund. Independent actuaries value this scheme annually, and the last valuation was carried out at 31 December 2012. The actuary's opinion is that the plan is in a sound financial position.

	2012 R'000	2011 R'000	2010 R'000	2009 R'000	2008 R'000
The amounts recognised in the statement of financial position are as follows (refer to note 17):					
Present value of total service liabilities	**21 575**	18 577	20 648	19 370	19 664
Fair value of plan assets	**(2 103)**	(2 528)	(5 499)	(5 507)	(5 133)
Provident fund	**(1 315)**	(1 800)	(1 832)	(1 674)	(922)
Endowment bond	**(788)**	(728)	(2 530)	(2 718)	(3 118)
Annuities	**–**	–	(1 137)	(1 115)	(1 093)
Liability in the statement of financial position	**19 472**	16 049	15 149	13 863	14 531
The amounts recognised in the statement of comprehensive income are as follows (refer to note 25):					
Current service cost	**13**	53	50	92	89
Interest costs	**1 466**	1 636	1 767	1 785	1 568
Expected return on plan assets	**(234)**	(509)	(578)	(526)	(529)
Discharge of liability and related plan asset	**–**	486	–	–	–
Actuarial gain/(loss)	**3 685**	767	1 488	(660)	368
Employer benefit payments	**(1 507)**	(1 533)	(1 441)	(1 359)	(1 308)
Total included in staff costs	**3 423**	900	1 286	(668)	188
Reconciliation of the movement in the present value of total service liabilities:					
At the beginning of the year	**18 577**	20 648	19 370	19 664	20 223
Current service cost	**13**	53	50	92	89
Interest costs	**1 466**	1 636	1 767	1 785	1 568
Discharge of liability	**–**	(1 891)	–	–	–
Actuarial gain/(loss)	**3 026**	(336)	902	(812)	(908)
Employer benefit payments	**(1 507)**	(1 533)	(1 441)	(1 359)	(1 308)
At the end of the year	**21 575**	18 577	20 648	19 370	19 664
Reconciliation of the movement in the fair value of plan assets:					
At the beginning of the year	**2 528**	5 499	5 507	5 133	5 880
Expected return on plan assets	**234**	509	578	526	529
Non-qualifying plan assets as a result of discharge of liability	**–**	(2 377)	–	–	–
Actuarial (loss)	**(659)**	(1 103)	(586)	(152)	(1 276)
At the end of the year	**2 103**	2 528	5 499	5 507	5 133

The principal actuarial assumptions used were as follows:

Discount rate	**7.25%**	(2011: 8.25%) compounded annually
Investment return	**8.25%**	(2011: 9.25%) compounded annually
Rate of medical inflation	**7.75%**	(2011: 7.25%) compounded annually
Salary inflation	**7.25%**	(2011: 6.75%) compounded annually

The effect of a 1% increase/decrease on the assumed rate of medical inflation, would be an increase in the liability in an amount of R1.674 million (2011: R1.613 million) and a decrease of R1.394 million (2011: R1.361 million), respectively.

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
19. Other accounts payable		
Loan from the holding company (refer to note 28.2)	**504**	–
Accruals	**11 949**	15 633
Product-related credits	**39 510**	73 814
Sundry creditors	**6 945**	12 428
	58 908	101 875
20. Contingent liabilities and commitments		
20.1 Guarantees, letters of credit and committed undrawn facilities		
Guarantees	**300 496**	294 263
Shipping	**117**	–
Lending related	**8 219**	8 431
Mortgage	**81 526**	97 694
Performance	**210 634**	188 138
Letters of credit	**15 634**	24 883
Committed undrawn facilities	**66 314**	82 050
	382 444	401 196
20.2 Commitments under operating leases		
The total minimum future lease payments under operating leases are as follows:		
Property rentals:		
Due within one year	**20 605**	20 746
Due between one and five years	**82 163**	78 318
Due between five and 10 years	**–**	21 421
	102 768	99 064
After tax effect on operating leases	**73 993**	71 326

A register containing details of the existence and terms of renewal and escalation clauses, is available for inspection at the registered office of the Company.

	2012 R'000	2011 R'000
21. Interest income		
Loans to subsidiaries and fellow subsidiaries	**20 599**	8 942
Loans and receivables	**486 288**	429 573
Cash and cash equivalents	**45 627**	61 480
Negotiable securities	**13 381**	14 287
Loans and advances	**427 280**	353 806
Loans and receivables designated at fair value through profit and loss		
Loans and advances	**4 189**	7 444
Held-for-trading		
Interest rate swaps	**–**	37
	511 076	445 996

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
22. Interest expense		
Deposits	**179 220**	176 935
Long-term funding*	**24 051**	1 832
Held-for-trading		
Interest rate swaps	**1 304**	2 831
Other	**18**	–
	204 593	181 598

*Includes charges relating to arrangement and commitment fees on unutilised long-term funding for the year.

	2012 R'000	2011 R'000
23. Non-interest income		
Fee and commission income		
Loans and receivables	**260 442**	238 294
Trading income	**71 284**	68 961
Held-for-trading	**71 295**	66 229
Foreign currency	**70 950**	66 237
Derivative assets	**70**	(59)
Derivative liabilities	**275**	51
Designated at fair value through profit and loss	**(11)**	2 732
Loans and advances	**(11)**	(79)
Other investments	**–**	2 811
Investment income		
Dividends	**434**	364
	332 160	307 619

	2012 R'000	2011 R'000
24. Fee and commission expenditure		
Foreign currency	**26 999**	21 984
Commissions and transactions	**100 076**	102 161
	127 075	124 145

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
25. Operating expenditure		
Amortisation (refer to note 2)	**24 863**	25 740
Auditors' remuneration		
Audit fees – current year	**6 175**	6 450
Fees for other services – Tax advisory fees	**180**	170
– IT due diligence	**–**	62
– Other	**20**	47
	6 375	6 729
Depreciation (refer to note 3)	**9 621**	8 241
Directors' remuneration (refer to note 28.3)		
Executive Directors	**14 388**	12 785
Non-Executive Directors' fees	**4 429**	3 859
	18 817	16 644
Indirect tax		
Non-claimable Value-Added Tax	**9 271**	9 170
Skills development levy	**1 433**	1 174
	10 704	10 344
Profit on sale of property and equipment	**(6)**	–
Marketing	**1 862**	1 418
Operating leases for premises and related costs	**25 112**	23 609
Other operating costs	**49 107**	45 556
Professional fees		
Consulting	**2 532**	2 737
Legal and collection	**1 169**	1 189
Computer consulting and services	**37 867**	41 524
	41 568	45 450
Staff costs		
Salaries, allowances and incentives	**140 143**	122 810
Post-retirement medical benefits (refer to note 17)	**3 423**	900
Share-based payments and deferred bonus scheme expense, including Executive Directors	**3 864**	4 257
Other	**4 133**	2 776
	151 563	130 743
Total operating expenditure	**339 586**	314 474
Number of persons employed by the Company at year-end	**403**	404

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
26. Tax		
South African normal tax	**404**	–
Current year	**404**	–
Prior year	**–**	–
Deferred tax	**45 781**	42 676
Current year	**45 812**	39 515
Prior year	**(31)**	3 161
	46 185	42 676
Direct tax		
South African normal tax	**404**	–
South African tax rate reconciliation		
South African standard tax rate (%)	**28.00**	28.00
Exempt income (%)	**(0.05)**	(7.58)
Expenses not deductible for tax purposes (%)	**1.19**	–
Additional allowances for tax purposes (%)	**(0.06)**	(2.71)
Capital gain – 50% of realised portion taxable (%)	**(4.13)**	–
Under provision prior year (%)	**0.00**	1.42
Effective tax rate (%)	**24.95**	19.13
Estimated tax losses available for offset against future taxable income	**–**	160 296

	2012 R'000	2011 R'000
27. Notes to statement of cash flows		
27.1 Cash receipts from customers		
Interest income	**511 076**	445 996
Non-interest income and gains on disposal and fair value adjustments on investments	**373 270**	407 468
Adjusted for: Dividends received	**(434)**	(60 364)
Net (gain) on disposal of investments	**(14 832)**	–
Revaluation of fair value financial instruments	**(679)**	(34 104)
Recoveries in respect of amounts previously written off	**138**	727
	868 539	759 723
27.2 Cash paid to customers, suppliers and employees		
Interest expense	**(204 593)**	(181 598)
Operating expenditure and fee and commission expenditure	**(466 661)**	(438 619)
Adjusted for: Amortisation	**24 863**	25 740
Depreciation	**9 621**	8 241
Write-off of obsolete assets	**877**	833
Vesting of shares in the conditional share plan	**–**	(1 544)
Share-based payments expense	**3 864**	4 257
Increase in provisions and other liabilities	**21 951**	12 989
	(610 078)	(569 701)

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

	2012 R'000	2011 R'000
27. Notes to statement of cash flows (continued)		
27.3 Reconciliation of profit before tax to cash generated from operations		
Profit before tax	**185 100**	223 026
Profit before tax adjusted for:		
Dividends received	**(434)**	(60 364)
Net (gain) on disposal of investments	**(14 832)**	–
Revaluation of fair value financial instruments	**(679)**	(34 104)
Net impairments raised	**28 130**	10 948
Amortisation	**24 863**	25 740
Depreciation	**9 621**	8 241
Write-off of obsolete computer software	**877**	833
Vesting of shares in the conditional share plan	**–**	(1 544)
Deferred bonus scheme expense	**3 864**	4 257
Increase in provisions and other liabilities	**21 951**	12 989
Cash generated from operations	**258 461**	190 022
27.4 Tax		
Amounts paid at the beginning of the year	**–**	–
Statement of comprehensive income (charge)	**(404)**	–
Less: Amounts (overpaid) at the end of the year	**(1 262)**	–
Total tax (paid)	**(1 666)**	–
27.5 Net movement in income-earning assets		
(Increase)/Decrease in negotiable securities	**(64 652)**	72 588
(Increase) in loans and advances	**(795 144)**	(646 202)
Net (increase) in income-earning assets	**(859 796)**	(573 614)
27.6 Net movement in deposits and other accounts		
Increase/(Decrease) in deposits	**465 266**	(294 034)
Decrease/(Increase) in other accounts receivable	**8 130**	(7 019)
(Decrease)/Increase in other accounts payable	**(42 967)**	30 710
Net increase/(decrease) in deposits and other accounts	**430 429**	(270 343)

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

28. Related party information

28.1 Identity of related parties with whom transactions have occurred

The ultimate holding company (CGD), holding company (MBHL), direct and fellow subsidiaries, a joint venture (Mercantile E-Bureau (Pty) Ltd) and Directors are related parties. There are no other related parties with whom transactions have taken place, other than as listed below.

28.2 Related party balances and transactions

The Company, in the ordinary course of business, enters into various financial services transactions with related parties. Except for the interest-free loan between the Bank and MBHL, transactions are governed by commercial terms.

Balances with the holding company, direct and fellow subsidiaries: and joint venture

	% Held	**2012 R'000**	2011 R'000
Loans to/(from) subsidiaries			
Portion 2 of Lot 8 Sandown (Pty) Ltd	100	**(7 128)**	87 205
LSM (Troyeville) Properties (Pty) Ltd	100	**7 618**	7 352
Custom Capital (Pty) Ltd	74.9	**328 599**	158 889
Shareholder loan (refer to note 6)		**96 291**	106 305
Current account (included as part of loans and advances – refer to note 10)		**232 308**	52 584
Less: Provisions held against loan accounts		**(1 485)**	(3 555)
		327 604	249 891
Loans to/(from) the holding company, fellow subsidiary and joint venture			
Mercantile Bank Holdings Limited		**(504)**	–
Mercantile Insurance Brokers (Pty) Ltd		**25**	48
Mercantile E-Bureau (Pty) Ltd		**1 367**	1 154
		888	1 202
Deposits from holding company, fellow subsidiaries and joint venture			
Mercantile Bank Holdings Limited		**222**	223
Mercantile Insurance Brokers (Pty) Ltd		**2 055**	2 111
Multi Risk Investment Holdings (Pty) Ltd (disposed of effective 29 June 2012)		**–**	20 020
Mercantile E-Bureau (Pty) Ltd		**27**	207
		2 304	22 561

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

28. Related party information (continued)

28.2 Related party balances and transactions (continued)

Transactions with the holding company, direct and fellow subsidiaries and joint venture:

	2012 R'000	2011 R'000
Interest received from:		
Portion 2 of Lot 8 Sandown (Pty) Ltd	**1 295**	3 373
LSM (Troyeville) Properties (Pty) Ltd	**805**	761
Custom Capital (Pty) Ltd	**18 108**	4 681
Multi Risk Investment Holdings (Pty) Ltd (disposed of effective 29 June 2012)	**391**	127
Interest paid to:		
Portion 2 of Lot 8 Sandown (Pty) Ltd	**363**	–
Mercantile Insurance Brokers (Pty) Ltd	**78**	83
Custom Capital (Pty) Ltd	**–**	1 608
Non-interest income earned from:		
Mercantile Insurance Brokers (Pty) Ltd	**9**	98
Custom Capital (Pty) Ltd	**163**	74
Multi Risk Investment Holdings (Pty) Ltd (disposed of effective 29 June 2012)	**31**	–
Mercantile E-Bureau (Pty) Ltd	**25 521**	22 422
Dividends earned from:		
Portion 2 of Lot 8 Sandown (Pty) Ltd	**–**	60 000
Dividends paid to:		
Mercantile Bank Holdings Limited	**117 683**	59 929
Operating expenditure paid to:		
Portion 2 of Lot 8 Sandown (Pty) Ltd	**16 648**	14 961
LSM (Troyeville) Properties (Pty) Ltd	**1 134**	628

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

	2012 R'000	2011 R'000
CGD – Lisbon (Branch of CGD)	**(960)**	7 299
Nostro accounts	**400**	7 869
Vostro accounts	**(1 360)**	(570)
CGD – Paris (Branch of CGD)	**(36)**	(2 124)
Nostro accounts	**–**	148
Vostro accounts	**(36)**	(2 272)
CGD – London (Branch of CGD)		
Vostro accounts	**(14)**	(15)
CGD	**(1 010)**	5 160
Banco Comercial e de Investimentos (BCI) – Mozambique (Subsidiary of CGD)	**(133 984)**	(134 801)
Vostro accounts	**(3 656)**	(4 543)
Fixed deposits	**(130 085)**	(102 800)
Call and notice deposits	**(243)**	(27 458)
Total CGD	**(134 994)**	(129 641)

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

	2012 R'000	2011 R'000
Interest paid by CGD to the Bank	**–**	1 973
Interest paid by the Bank to BCI	**8 708**	7 883

Other

Post-retirement medical plan

Details of the post-retirement medical plan are disclosed in note 18.

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

28. Related party information (continued)

28.3 Director and Director-related activities

There were no material transactions with Directors other than the following:

	Directors' fees R'000	Salary R'000	Fringe benefits R'000	Retirement funds and medical aid contributions R'000	Performance bonus R'000	Total R'000
2012						
Non-Executive Directors						
J A S de Andrade Campos	**1 625**	–	–	–	–	**1 625**
G P de Kock	**667**	–	–	–	–	**667**
L Hyne	**629**	–	–	–	–	**629**
A T Ikalafeng	**533**	–	–	–	–	**533**
T H Njikizana	**600**	–	–	–	–	**600**
D Naidoo (appointed 23 May 2012)	**375**	–	–	–	–	**375**
Executive Directors						
D J Brown	–	**3 186**	–	**341**	**3 570**	**7 097**
K R Kumbier	–	**2 464**	–	**260**	**1 950**	**4 674**
J P M Lopes	–	**1 977**	**463**	**77**	**100**	**2 617**
	4 429	**7 627**	**463**	**678**	**5 620**	**18 817**
2011						
Non-Executive Directors						
J A S de Andrade Campos	1 547	–	–	–	–	1 547
G P de Kock	635	–	–	–	–	635
L Hyne	599	–	–	–	–	599
A T Ikalafeng	507	–	–	–	–	507
T H Njikizana	571	–	–	–	–	571
Executive Directors						
D J Brown	–	3 028	–	323	2 800	6 151
K R Kumbier	–	2 342	–	252	1 400	3 994
J P M Lopes	–	1 835	312	43	450	2 640
	3 859	7 205	312	618	4 650	16 644

	2012 R'000	2011 R'000
Share-based payments and deferred bonus scheme expense relating to Executive Directors		
D J Brown	**1 039**	1 213
K R Kumbier	**995**	1 209
Loans to Executive Directors		
J P M Lopes	**154**	205
Amounts paid by CGD to Executive Directors		
J P M Lopes	**544**	681

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

28. Related party information (continued)

28.3 Director and Director-related activities (continued)

Service agreements

D J Brown, Chief Executive Officer

Mr Brown's employment contract as Chief Executive Officer was extended by the Board in 2011 to March 2014. However, effective 1 April 2013 Mr Brown will become a Non-Executive Director until March 2014.

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

J P M Lopes, Executive Director

Mr Lopes has been seconded to Mercantile by CGD.

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

K R Kumbier, Deputy Chief Executive Officer

Mr Kumbier was employed by Mercantile as Executive Director: Finance and Business on 1 June 2010. He was appointed Deputy Chief Executive Officer effective 1 April 2012 and with effect 1 April 2013 has been appointed Chief Executive Officer.

Share options

In terms of the share option scheme, the following share options in MBHL were granted to D J Brown which were exercised in 2012:

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

Conditional share and deferred bonus scheme awards

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

During 2012, of the 5 000 000 phantom awards granted to D J Brown, 1 250 000 phantom awards were cash settled at a proxy price of 58.1 cents each. The balance of awards (3 750 000) were forfeited as the performance conditions in terms of the plan were not achieved.

In terms of the conditional share plan, conditional share awards were granted to D J Brown and K R Kumbier. During 2011 these unvested awards were converted into a deferred bonus scheme and the phantom awards not yet vested are as follows:

D J Brown:

- 5 000 000* at an estimated proxy price as at 31 December 2012 of 62.4 cents each;
- 7 500 000* at an estimated proxy price as at 31 December 2012 of 68.7 cents each; and
- 6 000 000* at an estimated proxy price as at 31 December 2012 of 71.0 cents each;

  * In terms of the change in the contractual conditions relating to Mr. Brown's employment contract, as outlined in service agreements above, these awards will be settled for a consideration of R2.8 million in April 2013.

K R Kumbier:

- 10 000 000 at an estimated proxy price as at 31 December 2012 of 62.4 cents each (only 25% will vest in 2013);
- 5 000 000 at an estimated proxy price as at 31 December 2012 of 68.7 cents each; and
- 3 500 000 at an estimated proxy price as at 31 December 2012 of 71.0 cents each.

Directors' interests

Except for K R Kumbier who holds nil (2011: 2 016 851) shares directly, no other Director held beneficial and/or non-beneficial interests, directly or indirectly, in shares issued by MBHL.

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

29. Share-based payments

Share option scheme

As from 2007, no options have been granted to employees of the Bank under this scheme and as at 31 December 2011 all options issued under the scheme had vested. Due to the share buy-back of MBHL's shares, all options were exercised by the Bank's employees and in terms of the Scheme of Arrangement for the delisting of MBHL option holders, received 52 cents per share minus the exercise price per option. The Mercantile Share Incentive Trust, which acted as agent on behalf of the Bank in respect of this scheme, was subsequently dissolved during 2012.

Conditional Share Plan

This scheme was implemented in 2008 but due to the ongoing lack of liquidity of MBHL's shares in the market, the Board decided to discontinue new awards under the scheme in 2011. All existing unvested awards were converted to a new cash-settled conditional phantom share plan, which is a deferred bonus scheme (refer to note 17).

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

	Exercise price (cents)	Options at the beginning of the year	Forfeited/ Lapsed during the year	Exercised during the year	Options at the end of the year	Exercisable options at the end of the year	Relating to Directors*
Share option scheme							
Grant date							
2012							
11 February 2002	**32**	**160 000**	**–**	**(160 000)**	**–**	**–**	**–**
5 October 2004	**18**	**5 000 000**	**–**	**(5 000 000)**	**–**	**–**	**5 000 000**
7 October 2004	**17**	**250 000**	**–**	**(250 000)**	**–**	**–**	**–**
11 February 2005	**20**	**500 000**	**–**	**(500 000)**	**–**	**–**	**–**
27 July 2005	**32**	**750 000**	**–**	**(750 000)**	**–**	**–**	**–**
9 February 2006	**41**	**750 000**	**–**	**(750 000)**	**–**	**–**	**–**
22 March 2006	**40**	**9 800 000**	**(150 000)**	**(9 650 000)**	**–**	**–**	**7 000 000**
26 February 2007	**34**	**15 750 000**	**(150 000)**	**(15 600 000)**	**–**	**–**	**8 000 000**
		32 960 000	**(300 000)**	**(32 660 000)**	**–**	**–**	**20 000 000**
2011							
20 November 2001	32	394 400	(394 400)	–	–	–	–
11 February 2002	32	160 000	–	–	160 000	160 000	–
5 October 2004	18	5 000 000	–	–	5 000 000	5 000 000	5 000 000
7 October 2004	17	250 000	–	–	250 000	250 000	–
11 February 2005	20	500 000	–	–	500 000	500 000	–
27 July 2005	32	750 000	–	–	750 000	750 000	–
9 February 2006	41	750 000	–	–	750 000	750 000	–
22 March 2006	40	9 800 000	–	–	9 800 000	9 800 000	7 000 000
26 February 2007	34	16 150 000	(400 000)	–	15 750 000	15 750 000	8 000 000
1 June 2007	36	500 000	(500 000)	–	–	–	–
		34 254 400	(1 294 400)	–	32 960 000	32 960 000	20 000 000

*Refer to note 28.3

Notes to the annual financial statements

for the year ended 31 December 2012 (continued)

29. Share-based payments (continued)

Conditional Share Plan

Grant date	Market price at date of grant (cents)	Conditional awards at the beginning of the year	Granted during the year	Forfeited/ Lapsed during the year	Settled during the year	Conversion of the scheme during the year	Conditional awards at the end of the year
2011							
22 February 2008	32	21 515 000	–	(16 406 250)	(5 108 750)	–	–
26 March 2008	31	4 000 000	–	(3 000 000)	(1 000 000)	–	–
24 July 2008	26	375 000	–	(281 250)	(93 750)	–	–
1 November 2008	28	2 000 000	–	(1 500 000)	(500 000)	–	–
18 March 2009	26	14 500 000	–	(11 500 171)	(212 329)	(2 787 500)	–
1 July 2009	25	1 000 000	–	(819 178)	(180 822)	–	–
25 February 2010	20	20 050 000	–	(4 917 124)	(182 876)	(14 950 000)	–
1 June 2010	24	10 000 000	–	–	–	(10 000 000)	–
1 December 2010	20	1 500 000	–	–	–	(1 500 000)	–
25 March 2011	21	–	24 050 000	(200 000)	–	(23 850 000)	–
		74 940 000	24 050 000	(38 623 973)	(7 278 527)	(53 087 500)	–

Risk management and control

Risk management philosophy

The Bank recognises that the business of banking and financial services is conducted within an environment of complex inter-related risks that have become all too evident during the ongoing global financial crisis. The Bank operates in a dynamic environment where the past is not necessarily an acceptable guide to the future. Risk management is a key focus of the Bank, and addresses a wide spectrum of risks that are continually evaluated, and policies and procedures reviewed and stress-tested to adapt to changing circumstances. In any economy, there are sectors that are more vulnerable to cyclical downturns than others. Economic variables are monitored to assist in managing exposure to such sectors. The concentration of risk in our target market sectors is managed to achieve a balanced portfolio. However, the Bank acknowledges the potential of concentration risk in being a niche bank, and this is carefully monitored, and where appropriate, corrective action is taken. Our business development efforts are focused on the stronger companies and individuals within established policy criteria, which policy serves to eliminate weaker credit from the portfolio. The Bank remains well positioned to effectively manage identified threats in a way that minimises risks to the Bank. Continuous risk management and controls reviews were undertaken by senior staff members during 2012, to identify material control weaknesses. No material weaknesses were identified, and the risk environment is considered to be mature. This process will continue during 2013.

A philosophy of enterprise-wide risk management within a Risk Management Monitoring and Control Framework has been implemented to ensure that all business and operational risks are managed effectively within acceptable risk profiles, policies and parameters. Risk management policies are essentially conservative, with proper regard to the mix of risk and reward. Existing policies, methodologies, processes, systems and infrastructure are frequently evaluated for relevance, to ensure that they remain at the forefront of risk management, and in line with regulatory developments and emerging best practices. The Bank takes all necessary steps to safeguard its depositors' funds, its own asset base, and shareholders' funds.

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

- further enhancements to the ALM monitoring and reporting process;
- the development of a Risk Tolerance Framework that has been approved by the Board;
- further enhancement and expansion to the prudential management schedule, wherein all risk-related ratios are monitored and reported to the ALCO and Board on a monthly basis. These enhancements include monitoring various Basel III-related ratios;
- a comprehensive review of the risk control self-assessment process across all key areas of the Bank;
- alignment of risk management methodologies and techniques in subsidiary companies;
- expansion of various scenario analyses, stress testing, and back testing;
- preparation to comply with the requirements of the new SARB regulatory returns, which included participation in the various quantitative impact studies and parallel runs;
- review and reinforcement of compliance with the 11 Principles of Sound Practices for the Effective Management and Supervision of Operational Risk;
- review and reinforced compliance with the Principles of Sound Liquidity Risk Management and Supervision;
- development and deployment of an on-line training application, to ensure that staff stay abreast of regulatory and other changes;
- the Board approved a Recovery and Resolution Plan for the Bank; and
- review of the Funding Policy and Contingent Funding plan.

Enterprise-wide risk management

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

Risk management is performed on a Bank-wide basis, involving the Board and its various committees, credit management, senior management, risk management, business line management, finance and control, legal/compliance, treasury, and operations, with support from information technology. Independent oversight and validation by audit functions ensure a high standard of assurance across methodology, operational and process components of the Bank's risk and capital management processes.

Risk management life cycle/process

All of the Bank's policies and procedures manuals are subject to ongoing review, and are signed off by the relevant business unit heads. These standards are an integral part of the Bank's governance structure and risk management profile, reflecting the expectations and requirements of the Board in respect of key areas of control. The standards and effective maintenance of the risk control self-assessment process ensures alignment and consistency in the way that prevalent risk types are identified and managed, and form part of the various phases of the risk management life cycle, defined as:

Risk identification (and comprehension)

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

Risk management and control

(continued)

Risk management life cycle/process (continued)

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

Once risks have been identified, they need to be measured. Certain risks will lend themselves more easily to determination and measurability than others, but it is necessary to ascertain the magnitude of each risk, whether quantifiable or not, and whether direct or indirect.

To consider risk appetite and the alignment against broader financial targets, the Bank mainly considers the level of earnings, growth and volatility that it is willing to accept from certain risks that are core to its business. Economic and regulatory capital required for such transactions is also considered, together with the resultant return on the required capital. The Bank also maintains a capital buffer for unforeseen events and business expansion.

Risk management (as an independent function)

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

Risk monitoring (and compliance with documented policies)

Open, two-way communication between the Bank and the SARB is fundamental to the entire risk monitoring and supervisory process. To achieve this, responsible line heads are required to document conclusions and communicate findings to the ALCO, RMC and CREDCOM, and to the SARB, through Banks Act returns and periodic meetings.

Risk control (stress and back-testing)

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

Management of risk

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

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

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

Board Committees monitor various aspects of the identified risks within the Enterprise-wide Risk Management Framework, which include:

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

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

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

A process is in place whereby the Top 10 risks faced by the Bank are identified. These risks are assessed and evaluated in terms of a risk score attached to inherent risk and residual risk. Action plans are put in place to reduce the identified inherent risks to within acceptable residual risk parameters. The Top 10 risks are re-evaluated quarterly, and any changes are approved by the RMC. Business and Operating Divisions are integrally involved in the process in both risk identification and evaluation.

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

Risk management and control

(continued)

Management of risk (continued)

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

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

The Bank employs a comprehensive, consistent and integrated approach to stress testing that is ingrained as a business planning and management tool, emphasising scenario-based analyses. Stress testing measures potential volatility of earnings under various scenarios.

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

Credit risk

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

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

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

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

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

The Bank has adopted a conservative approach to credit granting, within a specifically defined and structured approval process. The granting of credit is managed via a mandated approval process, whereby levels of credit approval are determined by the experience of the mandated individual, with dual or multiple sign-off on all material values. An ongoing weekly review is also undertaken by the CREDCOM of all new and renewal proposals for lending in excess of R2 million (in aggregate). In addition, an early warning system is applied to actively manage all accounts within the risk structure. The system identifies a number of characteristics relating to the performance of the accounts, and based on various predefined algorithms, flags issues of concern. Monitoring is done by the Portfolio Management Department, and any concerns are raised with the Credit Department and Business or Commercial banking units.

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

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

The table below summarises the Bank's maximum exposure to credit risk at reporting date:

Risk management and control

(continued)

Credit risk (continued)

The table below summarises the Bank's maximum exposure to credit risk at reporting date:

	Loans and advances R'000	Committed undrawn facilities R'000	Other R'000	Total R'000
2012				
Current accounts	**1 340 870**	**–**	**–**	**1 340 870**
Credit cards	**22 227**	**13 702**	**–**	**35 929**
Mortgage loans	**2 435 482**	**52 612**	**–**	**2 488 094**
Instalment sales and leases	**285 334**	**–**	**–**	**285 334**
Structured loans	**44 579**	**–**	**–**	**44 579**
Medium-term loans	**1 115 512**	**–**	**–**	**1 115 512**
Negotiable securities	**–**	**–**	**257 514**	**257 514**
Cash and cash equivalents	**–**	**–**	**1 218 714**	**1 218 714**
Guarantees	**–**	**–**	**300 496**	**300 496**
Letters of credit	**–**	**–**	**15 634**	**15 634**
	5 244 004	**66 314**	**1 792 358**	**7 102 676**
2011				
Current accounts	983 266	–	–	983 266
Credit cards	19 777	14 049	–	33 826
Mortgage loans	2 053 662	68 001	–	2 121 663
Instalment sales and leases	307 770	–	–	307 770
Medium-term loans	103 081	–	–	103 081
Other advances	967 478	–	–	967 478
Negotiable securities	–	–	192 588	192 588
Cash and cash equivalents	–	–	936 911	936 911
Guarantees	–	–	294 263	294 263
Letters of credit	–	–	24 883	24 883
	4 435 034	82 050	1 448 645	5 965 729

Operational risk

Operational risks faced by the Bank are extensive, and include robbery, fraud, theft of data, systems access and controls, legal challenges, statutory and legislative compliance, operational processes, employment policies, documentation risk, and business continuity. Operational risk can also cause reputational damage, and therefore, efforts to identify, manage and mitigate operational risk are equally sensitive to reputational risk, as well as the risk of financial loss.

Operational risk management's aim is to enhance the level of risk maturity across the Bank, by implementing and embedding process-based risk and control identification and assessments, and integrating the operational risk management process in all business units, to ensure adequate risk management in an ever-changing business and financial industry.

Strategies, procedures and action plans to monitor, manage and limit the risks associated with operational processes, systems and external events, include:

- documented operational policies, processes and procedures with segregation of duties;
- ongoing training and up-skilling of staff on operational procedures and legislative compliance;
- an internal operational loss data base, wherein all losses associated with operational issues, including theft and robbery, are recorded and evaluated to facilitate corrective action;
- ongoing improvements to the Disaster Recovery and Business Continuity plans, including conducting a variety of simulation exercises in critical operations environments;
- conducting a variety of internal audits and reviews by both the Compliance and Internal Audit Departments, in line with annual plans approved by the Board;
- comprehensive data security and protection;
- ongoing review of the Bank-wide risk control self-assessment process, rolled out to job functional level in high-risk operational processing areas;
- ongoing review of key risk indicators, as a tool to further assist with risk identification and assessment;
- limiting access to systems and enforcing strong password controls; and
- a comprehensive insurance programme to safeguard the Bank's financial and non-financial assets.

Risk management and control
(continued)

Operational risk (continued)

The Bank subscribes to the 11 Principles of Sound Practices for the Effective Management and Supervision of Operational Risk. Compliance with the principles was reviewed, and action plans put in place to ensure compliance with the principles.

Technology risk

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

The Bank is currently in the final stages of implementing a new treasury system (BaNCS Treasury), which will interface with the core banking system (BaNCS). Significant progress has been made, and final implementation is scheduled for March 2013.

The Bank is in the final stages of selecting new IT services partners, in order to replace its current core IT services partner. The current service partner's contract is expiring in April 2013. Negotiations with new vendors are well underway and all services will be successfully transitioned before the end of the second quarter of 2013. The Bank does not have any unmitigated concerns regarding this transition.

A number of IT-related initiatives were implemented, and others further entrenched during the year. These included:

- development of IT governance and information security frameworks;
- comprehensive review of the core banking system's infrastructure;
- ODS rectification project;
- consolidation of the Oracle Database;
- redesign of the network boundary defence; and
- ongoing upgrade of the Bank's disaster-recovery capabilities.

Market risk

Market risk is the risk of revaluation of any financial instrument as a consequence of changes in market prices or rates, and can be quantified as the potential change in the value of the banking book, as a result of changes in the financial environment between now and a future point in time. The Board determines market risk limits. These limits are reviewed at least annually, depending on market events.

The Bank does not currently take proprietary trading positions, and therefore has minimal exposure to market risk. Should the Bank consider entering into a proprietary trading position, the Trading Committee and RMC will have to evaluate and approve entering into such positions. The Trading Committee will ensure that the Bank is prudently positioned, taking into account agreed limits, policies, prevailing markets, available liquidity, and the relationship between risk and reward, primarily to the financial risks of changes in foreign currency exchange rates and interest rates.

The Bank enters into derivative financial instruments to manage its exposure to interest rate and foreign currency risk, including:

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

Detailed market risk reports are produced on a daily basis, which allows for monitoring against prescribed prudential and regulatory limits. In the unlikely event of an unauthorised limit violation, the ALM forum records such violation, and is immediately corrected and reported to the ALCO, which is a management committee accountable to the RMC.

The Bank does not perform a detailed sensitivity analysis on the potential impact of a change in exchange rates on a daily basis, due to the fact that the Bank does not currently have any proprietary trading positions. The impact of changes in open foreign currency client positions is modelled, to take cognisance of credit risks associated with volatility in foreign currency exchange rates, with the purpose of covering adverse positions through calling for initial and variation margins. A detailed sensitivity analysis is performed for liquidity and interest rate risk (described on pages 48 to 52).

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

Foreign currency risk

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

The Bank has conservative limits in terms of net open foreign currency positions that are well below the limits allowed by the SARB. For the year under review, the highest net open position recorded for any single day, was R7.5 million (2011: R5.5 million). An adverse movement in the exchange rate of 10% would reduce the Bank's income by R0.6 million (2011: R0.5 million).

Risk management and control

(continued)

Foreign currency risk (continued)

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

	US Dollar R'000	Euro R'000	Pound Sterling R'000	Other R'000	Total R'000
2012					
Total foreign exchange assets	**86 031**	**23 781**	**3 724**	**7 164**	**120 700**
Total foreign exchange liabilities	**(87 604)**	**(16 970)**	**(1 773)**	**(96)**	**(106 443)**
Commitments to purchase foreign currency	**143 367**	**42 352**	**17 271**	**4 480**	**207 470**
Commitments to sell foreign currency	**(141 499)**	**(50 117)**	**(18 861)**	**(7 079)**	**(217 556)**
Year-end effective net open foreign currency positions	**295**	**(954)**	**361**	**4 469**	**4 171**
2011					
Total foreign exchange assets	596 992	16 673	4 780	16 490	634 935
Total foreign exchange liabilities	(96 000)	(8 534)	(1 061)	(12)	(105 607)
Commitments to purchase foreign currency	262 255	89 071	4 790	7 893	364 009
Commitments to sell foreign currency	(763 088)	(96 877)	(9 020)	(22 700)	(891 685)
Year-end effective net open foreign currency positions	159	333	(511)	1 671	1 652

Interest rate risk

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

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

The objective with the management of interest rate risk is to ensure a higher degree of interest rate margin stability and lower interest rate risk over an interest rate cycle. This is achieved by hedging material exposures and by not allowing any proprietary interest rate positions. Under interest rate swap contracts, the Bank agrees to exchange the difference between fixed and floating interest rate amounts, calculated on agreed notional principal amounts. Such contracts enable the Bank to mitigate the risk of changing interest rates on the fair value of issued fixed rate debt, and the cash flow exposures on the issued variable rate debt. The floating rate on the interest rate swaps is based on the three-month JIBAR and/or prime rate. The Bank will settle the difference between the fixed and floating interest rate, on a net basis.

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

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

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

The yield on assets remained under pressure during 2012, as a result of the low interest rate environment in South Africa. South Africa was not immune to the global credit and liquidity crisis as well as market uncertainty, in respect of the longer-term interest rate trends. Net interest income was adversely impacted by the negative endowment effect, due to the current high levels of excess capital of the Bank, and the high level of non-interest-bearing customer deposits. Pressure on margins is likely to continue during 2013.

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

Risk management and control

(continued)

Interest rate risk (continued)

The impact on equity and profit and loss resulting from a change in interest rates, is calculated monthly based on management's forecast of the most likely change in interest rates. In addition to the above, the impact of a static bank-specific favourable and unfavourable interest rate movement of 50 and 200 basis points respectively, is calculated and monitored daily by the ALM forum. Various approved prudential limits are in place and monitored by the Daily ALM forum, and the results are reported to the ALCO and the Board regularly.

At the reporting date, a 50 basis point change in prevailing interest rates was applied as a sensitivity analysis, to determine the impact on earnings as a result of a change in interest rates. If interest rates increased/decreased by 50 basis points, and all other variables remained constant, the Bank's net profit and equity at year-end would increase by R8.9 million, or decrease by R5.1 million (2011: increase/decrease by R8.7 million/R7.9 million). This is mainly attributable to the Bank's exposure to interest rates on its surplus capital and lending and borrowings in the banking book.

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

	Up to 1 month R'000	1 – 3 months R'000	4 – 12 months R'000	1 – 5 years R'000	Over five years R'000	Non-interest sensitive R'000	Total R'000	Effective interest rate %
2012								
Assets								
Intangible assets	–	–	–	–	–	197 823	197 823	–
Property and equipment	–	–	–	–	–	19 069	19 069	–
Tax						1 262	1 262	
Other accounts receivable	–	–	–	–	–	61 447	61 447	–
Interest in subsidiaries	96 781	–	–	–	–	21 517	118 298	–
Other investments	–	–	–	–	–	19 822	19 822	–
Non-current assets held for sale	–	–	–	–	–	13 453	13 453	–
Loans and advances	5 235 545	–	–	28 962	–	(95 754)	5 168 753	9.37
Derivative financial instruments	–	–	–	–	–	6 565	6 565	–
Negotiable securities	2 330	36 076	200 468	18 640	–	–	257 514	5.77
Cash and cash equivalents	1 021 921	–	–	–	–	196 793	1 218 714	4.24
Total assets	**6 356 577**	**36 076**	**200 468**	**47 602**	**–**	**441 997**	**7 082 720**	
Equity and liabilities								
Shareholders' equity	–	–	–	–	–	1 685 877	1 685 877	–
Deferred tax liabilities	–	–	–	–	–	30 009	30 009	–
Long-term funding	494 983	–	–	–	–	(3 107)	491 876	7.80
Deposits	3 038 643	370 941	465 216	26 674	–	836 762	4 738 236	4.01
Derivative financial instruments	–	–	–	–	–	7 160	7 160	–
Provisions and other liabilities	–	–	–	–	–	70 654	70 654	–
Other accounts payable	–	–	–	–	–	58 908	58 908	–
Total equity and liabilities	**3 533 626**	**370 941**	**465 216**	**26 674**	**–**	**2 686 263**	**7 082 720**	
Financial position interest sensitivity gap	**2 8229-51**	**(334 865)**	**(264 748)**	**20 928**	**–**		**2 244 266**	
Derivative financial instruments	**2 273**	**27 814**	**–**	**(30 087)**	**–**		**–**	
Total net interest sensitivity gap	**2 825 224**	**(307 051)**	**(264 748)**	**(9 159)**	**–**		**2 244 266**	

Risk management and control
(continued)

Interest rate risk (continued)

	Up to 1 month R'000	1 – 3 months R'000	4 – 12 months R'000	1 – 5 years R'000	Over five years R'000	Non-interest sensitive R'000	Total R'000	Effective interest rate %
2011								
Assets								
Intangible assets	–	–	–	–	–	206 817	206 817	–
Property and equipment	–	–	–	–	–	20 002	20 002	–
Other accounts receivable	–	–	–	–	–	69 557	69 557	–
Interest in subsidiaries	–	–	–	–	–	204 240	204 240	–
Other investments	–	–	–	–	–	69 162	69 162	–
Deferred tax assets	–	–	–	–	–	16 935	16 935	–
Loans and advances	4 401 789	–	19 320	9 639	24 540	(96 804)	4 358 484	9.16
Derivative financial instruments	–	–	–	–	–	15 657	15 657	–
Negotiable securities	74 643	99 071	–	18 874	–	–	192 588	6.03
Cash and cash equivalents	452 960	266 927	–	–	–	217 024	936 911	4.66
Total assets	4 929 392	365 998	19 320	28 513	24 540	722 610	6 090 373	
Equity and liabilities								
Shareholders' equity	–	–	–	–	–	1 649 695	1 649 695	–
Deposits	3 157 786	322 780	665 110	3 708	–	123 586	4 272 970	4.12
Derivative financial instruments	793	1 587	–	–	–	14 750	17 130	–
Provisions and other liabilities	–	–	–	–	–	48 703	48 703	–
Other accounts payable	–	–	–	–	–	101 875	101 875	–
Total equity and liabilities	3 158 579	324 367	665 110	3 708	–	1 938 609	6 090 373	
Financial position interest sensitivity gap	1 770 813	41 631	(645 790)	24 805	24 540		1 215 999	
Derivative financial instruments	17 594	31 529	(17 594)	(31 529)	–		–	
Total net interest sensitivity gap	1 788 407	73 160	(663 384)	(6 724)	24 540		1 215 999	

Liquidity risk

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

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

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

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

To manage this risk, the Bank performs, among others, the following:
- the maintenance of a stock of readily available, high-quality liquid assets in excess of the statutory requirements, as well as a strong statement of financial position liquidity ratios;
- an assumptions-based sensitivity analysis, to assess potential cash flows at risk;
- the management of concentration risk, being undue reliance on any single counterparty or counterparty group, sector, market, product, instrument, currency and tenor;
- the maintenance of sources of funding for contingency funding needs;

Risk management and control

(continued)

Liquidity risk (continued)

- the monitoring of daily cash flow movements/cash flow requirements, including daily settlements and collateral management processes;
- targeting a diversified funding base, to avoid undue concentrations by investor, market source and maturity;
- the creation and monitoring of prudential liquidity risk limits; and
- the maintenance of an appropriate term mix of funding.

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

Macro-economic conditions continued to hinder growth in advances and specifically in deposits, as the banking sector in South Africa is characterised by certain structural features, such as a low discretionary savings rate, and a higher degree of contractual savings that are captured by institutions such as pension and provident funds and providers of asset management services. The Bank will continue to focus on gathering retail customer and longer-term deposits to reshape the structure of the balance sheet, and to ensure compliance with the Basel III liquidity requirements, which will be effective in 2015.

The two key liquidity ratios that were introduced by Basel III are the: Liquidity coverage ratio ("LCR"), which is designed to promote short-term resilience of the one-month liquidity profile, by ensuring that banks have sufficient high quality liquid assets to meet potential outflows in a stressed environment; and Net Stable Funding Ratio ("NSFR"), which is designed to measure the stability of long-term structural funding.

Both the LCR and the NSFR will be subject to a monitoring period, which will commence in January 2013, with full implementation and compliance of the LCR and NSFR in 2015 and 2018 respectively. The Bank also monitors other Basel III-related ratios, such as the Leverage Ratio, which is a measure of qualifying capital to both on- and off-balance-sheet exposures. The Bank currently meets all the requirements of the new regulations.

There were no significant changes in the Bank's liquidity position during the current financial year, or in the manner in which it manages and measures the risk. The Bank is adequately funded and able to meet all of its current and future obligations. During 2011, the Bank entered into a R491 million seven-year term loan with the IFC. The facility has been fully utilised.

The Bank is currently exploring the raising of term funding through the Securitisation of its home loan book, as well as its Custom Capital's rental finance book. If successful, this could result in raising approximately R850 million of term funding to cater for future growth in lending. This will also have a positive effect on Basel III requirements.

The remaining period to contractual maturity of financial liabilities of the Bank at the reporting date, which includes the interest obligation on un-matured deposits and derivatives calculated up to maturity date, is summarised in the table below:

	Up to 1 month R'000	**1 – 3 months R'000**	**4 – 6 months R'000**	**6 – 12 months R'000**	**Over 1 year R'000**
2012					
Deposits	**2 892 296**	**969 078**	**324 947**	**552 727**	**41 160**
Long-term funding	–	–	–	–	**703 131**
Derivative financial instruments	**3 054**	**2 329**	**96**	**142**	**1 540**
Other accounts payable	**58 407**	–	–	–	–
Guarantees, letters of credit and committed undrawn facilities	**382 444**	–	–	–	–
Operating lease commitments	**1 868**	**3 704**	**5 296**	**9 737**	**82 163**
	3 338 068	**975 111**	**330 339**	**562 606**	**827 994**
2011					
Deposits	2 926 067	612 370	290 107	442 203	36 954
Derivative financial instruments	6 505	4 862	2 737	1 439	1 587
Other accounts payable	150 578	–	–	–	–
Guarantees, letters of credit and committed undrawn facilities	401 196	–	–	–	–
Operating lease commitments	108 098	944	1 438	2 636	7 369
	3 592 444	618 176	294 282	446 278	45 910

Risk management and control

(continued)

Liquidity risk (continued)

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

	Assets R'000	Liabilities R'000	Total mismatch R'000
2012			
Maturing up to one month	**2 675 488**	**3 023 862**	**(348 374)**
Maturing between one and three months	**41 836**	**964 353**	**(922 517)**
Maturing between three and six months	**96 296**	**318 340**	**(222 044)**
Maturing between six months and one year	**517 537**	**529 075**	**(11 538)**
Maturing after one year	**3 458 326**	**530 701**	**2 927 625**
Non-contractual	**293 237**	**30 512**	**262 725**
	7 082 720	**5 396 843**	**1 685 877**
2011			
Maturing up to one month	1 990 716	3 082 265	(1 091 549)
Maturing between one and three months	377 537	612 864	(235 327)
Maturing between three and six months	12 682	286 658	(273 976)
Maturing between six months and one year	71 487	423 980	(352 493)
Maturing after one year	3 197 299	34 911	3 162 388
Non-contractual	440 652	–	440 652
	6 090 373	4 440 678	1 649 695

Basel III – influencing risk management developments at the Bank

In today's complex environment, combining effective bank-level management with market discipline and regulatory supervision, best achieves systemic safety and soundness. The Bank recognises the significance of Basel III in aligning regulatory capital to risk, and further entrenching risk reward principles and practices in bank management and decision-making.

The regulation and supervision of financial institutions continues to undergo significant change as a result of the global financial crisis. South Africa embraced the principles of the Basel III capital framework. This framework focuses on strengthening and harmonising global liquidity standards, to ensure that internationally active banks are adequately capitalised. The SARB have released the amendments to the Banks Act and Regulations to incorporate the requirements of the Basel III regulatory framework. These requirements will be phased in from 1 January 2013 in South Africa, with full compliance of capital and buffer levels by 1 January 2019.

The banking industry in South Africa will find it difficult to fully meet the new ratios ("LCR" and "NSFR") as a result of the structural characteristics and constraints in the South African environment. The SARB indicated that they will make available committed liquidity facilities to banks with insufficient High Quality Liquid Assets ("HQLA"), due to the fact that South Africa has virtually no Level II HQLA. This will enable banks to meet the LCR requirement. The cost for this facility will range from 15 to 30 basis points if not utilised. Utilisation of this facility will be limited to 30 days, at a cost of SARB's repo rate, plus 100 basis points for the utilisation period. Mercantile currently complies with the requirements of the LCR, and will therefore not apply to the SARB for such a facility in the foreseeable future.

The strategic impact of Basel III internationally is significant, as a result of additional costs to comply with regulatory developments, and the possibility that non-compliant banks will have to change their business model to meet the high liquidity requirements. Mercantile is well capitalised, and currently meets the Basel III capital and liquidity requirements. However, we believe that there could be a negative impact on overall margins in the short- to medium-term, and/or an increase in the cost of borrowing to clients. The Bank will continue to seek and adopt market best practice in accordance with these regulatory amendments.

Capital management

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

Risk management and control

(continued)

Capital management (continued)

Capital adequacy and the use of regulatory capital are monitored by employing techniques based on the guidelines documented in the Bank Regulations, and implemented by the SARB for supervisory purposes. The SARB uses the capital adequacy ratio of banks as a key supervisory tool. In terms of regulation, the Bank is able to consider different tiers of capital. The capital of the Bank consists almost entirely of tier 1 capital. Following the recapitalisation of the Bank in 2004, it has remained capitalised well beyond regulatory and internal requirements.

Risk-weighted capital is allocated to the different business units in line with their assessed operational risk profile and targeted growth requirements.

The level of capital for the Bank is as follows:

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

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

A substantial number of changes are proposed in Basel III, relating to the minimum required capital. It focuses mainly on the various qualifying forms of core tier 1 capital, and further deductions against capital. Mercantile is largely unaffected by these changes, due to the current high levels of tier 1 capital. The bulk of current qualifying capital will still qualify as tier 1 capital, when Basel III comes into effect in 2013.

	2012 R'000	2011 R'000
Risk-weighted assets – Banking book		
Credit risk	**4 993 711**	4 371 738
Operational risk	**952 817**	801 859
Market risk	**33 813**	170 063
Equity	**19 822**	63 152
Other assets	**126 424**	125 315
	6 126 587	5 532 127
Net qualifying capital and reserves		
Primary capital	**1 450 291**	1 410 686
Share capital and share premium	**1 483 300**	1 483 300
Retained earnings	**152 583**	127 983
General reserves	**12 231**	12 231
Less: Deductions	**(197 823)**	(212 828)
Secondary capital	**9 054**	3 509
General allowance for credit impairment	**9 020**	3 475
Surplus resulting from a revaluation of specified assets	**34**	34
	1 459 345	1 414 195
Capital adequacy ratio (%)	**23.8**	25.6
Primary capital (%)	**23.7**	25.5
Secondary capital (%)	**0.1**	0.1

Fraud

Payment card fraud

The Bank is an issuer of MasterCard and Visa cards and has, in line with the card associations' regulations, adopted proactive measures to prevent fraudulent use of these products. The Bank makes use of monitoring fraud reports, based on a set of parameters prescribed by the card associations, and is reviewed on a daily basis with the aim of identifying suspicious transactional behaviour.

In addition to standard monitoring measures, the Bank offers an SMS notification service on both its credit and debit card products. Since its introduction, this service has contributed to the early detection of fraudulent transactions and mitigation of losses.

If fraudulent activity is confirmed, action is taken to prevent further use of the card/card number. Confirmed fraudulent transactions are investigated and reported to the relevant card associations and the South African Banking Risk Information Centre ("SABRIC"), which determines common trends and then alerts the industry accordingly.

The Bank recently launched Merchant acquiring, and offers merchants point-of-sale devices to acquire transactions on behalf of VISA and MasterCard. In order to address the fraud risks associated with merchant acquiring, the Bank has implemented fraud prevention systems and merchant account monitoring tools that comply with the relevant card associations' requirements.

Fraud other than payment card fraud

The Bank has adopted a zero tolerance approach towards all types of fraud and theft. The Forensic Investigator investigates all incidents relating to external fraud, and internal fraud is investigated by our internal audit division.

Risk management and control

(continued)

Fraud (continued)

If an incident of fraud is brought to our attention, it is investigated immediately, evidence is collected, and statements are taken. If the incident was perpetrated externally, criminal charges are laid. If the incident was perpetrated internally, disciplinary action is instituted in addition to criminal charges being laid. All incidents are reported to the SABRIC and the South African Police Service.

Fraud Awareness:

Fraud awareness training is conducted on a regular basis, and awareness newsletters are compiled and disseminated to all staff. These newsletters address a wide range of topics, and are not limited to payment card fraud only. Fraud awareness newsletters are also compiled and distributed to clients.

During the latter part of 2012, the Fraud Department initiated a Fraud Awareness User Guide, consisting of a number of modules. The aim of each module is to cover specific and current fraud trends. Additional modules will be distributed during 2013, assisting staff to compile a comprehensive fraud awareness reference manual.

Fraud Department staff members attend meetings of industry role players, and utilise internet-based sources to stay abreast of fraud trends and the prevention thereof. The Bank also works closely with SABRIC, the Payment Association of South Africa, and card associations.

Whistle-blowing

The Bank has a comprehensive Protected Disclosures Policy based on the Act of the same name. The policy addresses the reporting of corrupt activities, as well as any improper conduct, under a section on whistle-blowing. Employees are encouraged to make disclosures in good faith and on reasonable grounds.

All employees receive, twice annually, an electronic step-by-step guide on what to report and how to report it.

To this end, an enhanced anonymous reporting system is in place to enable employees to report directly to Compliance and Internal Audit, using a web-based tool. This system simplifies the anonymous reporting procedure, and encourages employees to make use of the process.

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