

Business review Risk management

3i has a risk management framework which provides a structured and consistent process for identifying, assessing and responding to risks in relation to the Group's strategy and business objectives.

Introduction

Risk management operates at all levels throughout the Group, across business lines, geographies and professional functions. The Board is ultimately responsible for risk management, which includes the Group's risk governance structure and maintaining an appropriate internal control framework. Management's responsibility is to manage risk on behalf of the Board.

By reporting regularly to Audit and Compliance Committee, the Group's Compliance and Risk Assurance and Audit functions provide support to the Board in maintaining the effectiveness of risk management across the Group. Following a review of the Group's risk management processes in the year, a new monitoring framework was implemented, with a number of new committees providing input to Group Risk Management Committee. This became operational in March 2007 and formalised many existing practices. The diagram below shows this risk management framework and outlines the key responsibilities of each committee.

Risk governance

Group Risk Management Committee

- Responsible for overall risk management process
- Monitors changes in external risk environment
- Reviews reports from Investment, Operational and Financial Risk Committees
- Reports to Audit and Compliance Committee

Investment Committee

- Takes or recommends investment decisions on individual opportunities

Operational Risk Committee

- Provides input to the setting of investment policy and guidelines
- Deals with all aspects of operational risk

Financial Risk Committee

- Assesses financial risk including treasury and funding risk
- Will recommend asset allocation decisions and monitor portfolio composition through six-monthly reviews

Conflicts Committee

Decides issues on conflicts arising in investment process and other areas

Health and Safety Committee

Reviews Health and Safety arrangements and policy. Monitors implementation and performance

Corporate Responsibility Committee

Recommends socially responsible investment policy. Identifies and promotes awareness of Corporate Responsibility and developments and risks

Regulatory Risk Forum

Provides regulatory input to investment policy. Identifies and promotes awareness of regulatory developments and risks

Risk type	Brief description	Further information	Risk mitigation
External	Risks arising from political, legal, regulatory, economic policy and competitor changes	<ul style="list-style-type: none"> – Chairman’s statement – Chief Executive’s statement – Business review, Group business section 	<ul style="list-style-type: none"> – Entry into new geographical markets subject to extensive market research and due diligence – Close monitoring of regulatory and fiscal developments in main markets – Diversified investment portfolio in a range of sectors, with different economic cycles, across geographical markets
Strategic	Risks arising from the analysis, design and implementation of the Group’s business model, and key decisions on investment levels and capital allocations	<ul style="list-style-type: none"> – Business review, Group business, Our strategy section 	<ul style="list-style-type: none"> – Monitoring of a range of key performance indicators, forecasts and periodic updates of plans and underlying assumptions – Regular monitoring by Group Risk Management Committee
Investment	Risks in respect of specific asset investment decisions, the subsequent performance of an investment or exposure concentrations across business line portfolios	<ul style="list-style-type: none"> – Business review, Financial review section – Financial statements, Ten largest investments 	<ul style="list-style-type: none"> – Investment Committee approval of all significant investments – Regular asset reviews – Representation by a 3i investment executive on the boards of investee companies – Portfolio is subject to periodic reviews at both the business line and Group levels to monitor exposure to any one sector or geography
Treasury and funding	Risks arising from (i) uncertainty in market prices and rates, (ii) an inability to raise adequate funds to meet investment needs or meet obligations as they fall due, or (iii) inappropriate capital structure	<ul style="list-style-type: none"> – Business review, Financial review section – Financial statements, Notes to the financial statements 	<ul style="list-style-type: none"> – Credit risk exposure is managed on an asset-specific basis by individual investment managers – Board review of the Group’s financial resources every six months – Assets denominated in foreign currency broadly matched with borrowings in the same currency – Type and maturity of the borrowings broadly matched to those of the corresponding assets
Operational	Risks arising from inadequate or failed processes, people and systems or from external factors affecting these	<ul style="list-style-type: none"> – Corporate responsibility report 	<ul style="list-style-type: none"> – Line management at all levels is responsible for identifying, assessing, controlling and reporting operational risks – Framework of core values, standards and controls, a code of business conduct and delegated authorities are in place – Independent internal audit function carries out periodic reviews

The main components of each risk type and related risk mitigation measures are described overleaf. Further information can also be found under the relevant report sections referred to above.

External risks

Macroeconomic risks

3i invests mainly in European companies and continues to develop its operations in Asia and the US. The performance of the Group's underlying investment portfolio is influenced by economic growth, interest rates, currency movements and changes in commodity and energy prices. Market conditions for initial public offerings, the level of mergers and acquisitions activity, the number of active trade or other private equity buyers, and the availability of well-priced debt finance, all have an impact, not only on the Group's ability to invest but on the Group's ability to exit from its underlying portfolio, or on the levels of profitability achieved on exit.

To mitigate this, 3i aims to invest over time in a range of sectors, with different economic cycles, across its different business lines and geographical markets. This includes expansion in both the US and in Asia, which further diversifies the portfolio.

Geopolitical risk

Part of the Group's investment strategy is to invest in new and emerging markets. The legal, regulatory and capital frameworks in these markets may be less developed than in the other main geographical markets in which the Group operates. Changes and developments in all our markets are monitored closely to ensure that any impact on the value of existing investments, planned levels of investment or investment returns are, as far as possible, anticipated, understood and acted upon. This work includes periodic legal and regulatory updates by geography, in-depth market and sector research and regular reviews for existing investments. Entry into new geographical markets is subject to extensive market research and due diligence.

Government policy and regulation

3i Investments plc, a wholly owned subsidiary of 3i, is an authorised person under the Financial Services and Markets Act 2000 and regulated by the FSA in the United Kingdom. Where applicable, certain 3i Group subsidiaries' businesses outside the United Kingdom are regulated locally by relevant authorities. Changes to the regulatory frameworks under which the Group operates are closely monitored. There are also appropriate processes and procedures in place, including a dedicated Group Compliance function, whose remit is to minimise the risk of a breach of applicable regulations which could affect the Group's compliance costs, its business, results of operations or financial position.

3i carries on business as an investment trust under section 842 of the Income and Corporation Taxes Act 1988. Continuation of this status is subject to the Company directing its affairs in line with the relevant requirements of the legislation. Anticipated and actual changes in government policy and related tax treatment of investment trusts are closely monitored, as are other changes which could affect results of operations or financial position. Related risks exist in other jurisdictions in which the Group operates, where there is similar close monitoring of changes in local taxation legislation which could affect the expected tax position of the Group.

Strategic risks

The Group's strategy is based on a full analysis of its operating environment. In determining the appropriate business model, market and sector evaluations are taken into account, as well as the identification and assessment of external and internal risk factors. Significant unexpected changes or outcomes, beyond those factored into the Group's strategy and business model, may occur which could have an impact on the Group's performance or financial position.

This is addressed through the monitoring of a range of key performance indicators, forecasts and periodic updates of plans and underlying assumptions.

Investment risks

Investment decisions

The Group operates in a very competitive market. Changes in the number of market participants, the availability of funds within the market, the pricing of assets, or in the ability to access deals on a proprietary basis could have a significant effect on the Group's competitive position and on the sustainability of returns.

The ability of the Group to source and execute good quality investments in such markets is dependent upon a range of factors. The most important of these include: (i) the ability to attract and develop people with the requisite investment experience and cultural fit; (ii) organisation of teams whose structure is market-adapted and whose compensation is results-oriented; and (iii) effective application of collective knowledge and relationships to each investment opportunity.

3i's investment appraisal is undertaken in a rigorous manner. This includes approval by the relevant business line partnerships, and where appropriate, peer review by executives from other business lines, together with 3i's international network of industry and sector specialists. Investments over £5 million are presented to an Investment Committee chaired by an authorised member of the Management Committee and comprising our senior investment executives.

Investment performance

The performance of the Group's portfolio is dependent upon a range of factors. These include, but are not limited to: (i) the quality of the initial investment decision described above; (ii) the ability of the portfolio company to execute successfully its business strategy; and (iii) actual outcomes against the key assumptions underlying the portfolio company's financial projections. Any one of these factors could have an impact on the valuation of a portfolio company and upon the Group's ability to make a profitable exit from the investment within the desired timeframe.

A rigorous process is put in place for managing the relationship with each investee company for the period through to realisation. This includes regular asset reviews and, in many cases, board representation by a 3i investment executive.

Investment concentration

The Group invests across a range of economic sectors and geographies. Over-exposure to a particular sector or geography could increase the impact of adverse changes in macroeconomic or market conditions on the Group. An increase in the average size of investments over time could also increase the exposure of the Group to the performance of a small number of large investments, albeit in different sectors and/or geographies.

The portfolio is subject to periodic reviews at both the business line and Group levels to monitor exposure to any one sector or geography and to monitor the exposure to larger investments.

Investment valuations and exit opportunities

The valuation of 3i's unquoted portfolio and opportunities for realisation depend to some extent on stock market conditions and the buoyancy of the wider mergers and acquisitions market. Changes in market or macroeconomic conditions, could impact the valuation of portfolio assets and the ability to exit those investments profitably within the desired timeframe.

Treasury and funding risks

3i's funding objective is that each category of investment asset is broadly matched with liabilities and shareholders' funds according to the risk and maturity characteristics of the assets, and that funding needs are met ahead of planned investment.

Credit risk

3i's financial assets are predominantly unsecured investments in unquoted companies. The Group considers the maximum credit risk to be the carrying value of the asset. An increase in concentration of the portfolio in a particular sector or geography could increase credit risk. Likewise large or unexpected increases in interest rates could increase credit risk, particularly in companies which are highly leveraged.

The portfolio is well diversified and, for this reason, credit risk exposure is managed on an asset-specific basis by individual investment managers.

The Group's remaining financial assets are mainly in the form of deposits with banks of a credit rating of AA or better. Counterparty limits are set and closely monitored.

Liquidity risk

The Group invests from its own balance sheet using cash generated from its investing activities and its core funding. The Group also has available to it undrawn committed facilities. In addition to funding from its own balance sheet, the Group periodically raises third-party funds to co-invest in mid-market buyout transactions. It also invests indirectly through funds administered by third parties, or quoted investment vehicles.

Unexpected changes in the levels of investment and divestment activities or in interest rates could impact the availability of funds required for investment needs or to meet obligations as they fall due.

To address this, a range of cash flow forecasts are produced and updated on a regular basis for each business line and for the Group as a whole. The Board reviews the Group's financial resources every six months. This includes consideration of the currency hedging and maturity profile aspects, as well as liquidity, of the Group's current and forecast financial position.

Price risk

The valuation of unquoted investments depends upon a combination of market factors and the performance of the underlying asset. The Group does not currently hedge the market risk inherent in the portfolio but manages asset performance risk on an asset specific basis, as described earlier.

Foreign exchange risk

3i reports in sterling and pays dividends from its sterling profits. The Group seeks to reduce structural currency exposures by matching assets denominated in foreign currency with borrowings in the same currency. The Group makes some use of derivative financial instruments to effect foreign exchange management. The current policy is to hedge the main currency exposures in the range of 90%–100%.

Interest rate risk

3i has a mixture of fixed and floating-rate assets. The assets are funded with a combination of shareholders' funds and borrowings according to the risk characteristics of the assets. The Board seeks to minimise interest rate exposure by considering the average life profile of the various asset classes and adopting a portfolio approach to the interest rate hedging structure. Some derivative financial instruments are used to achieve this objective.

Operational risks

The Group is exposed to a range of operational risks which can arise from inadequate or failed processes, people and systems or from external factors affecting these. These include operational events such as human resources risks, legal and regulatory risks, information technology systems failures, business disruption and shortcomings in internal controls.

Line management at all levels is responsible for identifying, assessing, controlling and reporting operational risks. This is supported by a framework of core values, standards and controls, a code of business conduct and delegated authorities. There is also an independent internal audit function which carries out periodic reviews.

People

The ability to recruit, develop and retain capable people is of fundamental importance to achieving the Group's strategy. The Group operates in a competitive industry and aims to remunerate staff in line with market practice and to provide superior development opportunities. The Group has human resources policies and procedures covering recruitment, vetting and performance management, and appropriate processes in place to monitor their application. Staff engagement is also regularly evaluated and reported to the Board.

Business processes

The Group's information technology and treasury systems, as well as its business processes and procedures, support its operations and business performance.

The Group has policies and procedures covering information security, change management, business continuity and disaster recovery. These are subject to periodic testing.

Legal and regulatory

In order to conform to necessary legal and regulatory requirements across multiple jurisdictions, the Group operates a complex legal and corporate structure. This requires appropriate internal processes and procedures to be developed and followed, supported by professional teams with appropriate skills, drawing upon external resources where appropriate. There is also a Legal and Regulatory Risk Forum which meets at least four times a year to review and plan for forthcoming legal and regulatory changes which could impact the Group.