REPORT OF THE RISK AND PORTFOLIO MANAGEMENT COMMITTEE

Mr Kugan Thaver
Acting Chairman of the Risk and Portfolio Management Committee

Market overview

The continuation of the current economic volatility has resulted in banks being more cautious in their lending activities. This has led to the need for Development Finance Institutions (DFIs), such as the NEF, to play an increasing role in implementing Government's strategies in, for example, funding new industrial capacity and job creation.

Risk Management

The NEF adopts an Enterprise-Wide Risk Management (ERM) approach to risk management as contrasted with a silo approach. ERM looks at risks across all business lines and activities of the organisation and adopts a holistic view of risk management. The NEF's Risk Management Framework outlines the risk management process adopted at the NEF.

In line with good corporate governance, the Board of Trustees is accountable for the management of risk within the NEF. The Board has established a Risk and Portfolio Management Committee (RPMC) to assist it in overseeing the implementation of the risk management process at the NEF.

Board Risk and Portfolio Management Committee

The duties of this committee in the governance of risk include:

- Oversight of risk management activities within the NEF
- Review of risk registers and tracking of actions
- Dealing with compliance matters
- Reviewing and approving certain policies and procedures
- Reviewing and updating a Delegation of Authority Framework
- Monitoring the NEF invested portfolio

Key risks

The realisation of the strategic objectives presented by the NEF may be affected by the following five key risks as ranked in the NEF's organisational risk register:

Capital Erosion

The risk of the erosion of capital and exposure to high credit risk investments

The NEF is mandated to intervene in the economy through the provision of funding to black owned enterprises which, due to past economic imbalances, may be of a higher credit risk. This risk is exacerbated by economic downturns that may impact on funded businesses and their cash flows, leading to their inability to honour loan repayments and possible defaults on loans to the NEF. Internally, risk that the assessment processes of the NEF may not be able to inform appropriate investment decisions does exist as does the risk of not collecting amounts due and not being able to timeously identify distressed investments which it may be possible to rescue.

Inadequate controls mitigating this risk may lead to the capital base of the NEF eroding and being written off due to high levels of defaulting advances.

The controls introduced to mitigate this risk include the appointment of skilled and experienced management and staff in the fund management sector, managing the mix of start-ups versus later stage investments within investment policies, due diligence and approval processes, monitoring and credit collection processes and enhancing financial and pricing models to adapt to most recent experiences and developments in the development finance environment.

Capital adequacy

The risk that the NEF will not be financially sustainable and have inadequate capital to fund the planned programmes

The NEF is no longer allocated capital via the MTEF process and is required to sustain itself over the strategic planning period (three years) out of current capital and internally generated portfolio returns.

This risk will materialise should the current capital not be prudently managed and the investment portfolio become significantly impaired in the absence of future funding being allocated to the NEF or the NEF not being able to source additional capital.

Controls implemented to mitigate this risk involve the continuous highlighting of this capital adequacy risk to **the dti** and the National Treasury and continuing with the application for re-classification of the NEF from a Schedule 3A Public Entity.

A reclassification will allow the NEF to present a capital raising plan for purposes of funding programmes beyond the current strategic planning period.

Mandate implementation

The risk of the NEF not being able to meaningfully contribute towards its mandate

The mandate of the NEF is clearly set out within the NEF Act. However the risk does exist that in executing the mandate the NEF does not achieve the desired impact in advancing B-BBEE.

This risk could be exacerbated if management and staff do not fully understand the potential operational implementation of the mandate of the NEF, if they are inadequately skilled or lack the capacity to consistently monitor adherence to the mandate in all activities of the NEF.

This risk is mitigated through the development of funding products individually aligned to the overall strategy and mandate of the NEF. These products have their own specific criteria which have to be met in order for applicants to be eligible for funding. Further specific strategy is formally developed in response to areas of continuing market failure, e.g. the SME strategy. Each transaction will in future need to be assessed against a measure of impact termed the NEF Empowerment Dividend. This will further create a consistent base against which each application will need to be assessed for meeting the mandated criteria for funding.

Opportunity cost

The risk that the NEF will not be able to follow through on equity options secured in early stage projects

Through the NEF's Strategic Projects Fund, which focuses on developing early stage projects that have a high element of job creation and contribute towards economic development through priority sectors, the NEF may secure equity participation rights in the projects that it funds. The ability to follow through on these rights and secure equity participation at discounted values is dependent on the level of current and future capital available by the NEF. Should these rights not be exercised then there is a significant opportunity cost, as the NEF may not be able to participate in a viable project with a potentially high economic impact.

In order to mitigate this risk the NEF has developed a policy of closely monitoring and managing the investment pipeline in the Strategic Projects Fund. This enables it to balance current capital available against future needs should the transactions materialise. In this regard the NEF is continuing its engagement with National Treasury through **the dti** to secure schedule re-classification so as to position the NEF to be able to raise additional capital against this portfolio of investment opportunities.

Business risk

The risk that changes in external market conditions have a negative impact on the viability of funded transactions

The investment portfolio of the NEF consists of businesses in the commercial sector that are susceptible to normal business risks of fluctuations in commodity prices and foreign exchange rates, amongst other variables.

The portfolio is arguably more elastic and hence more susceptible to these variations given the nature of the businesses being supported i.e. early stage business, inexperienced entrepreneurs, and geared balance sheets and hence relatively unable to absorb the impact of these fluctuations compared with more established businesses.

In evaluating transactions, much work is performed during the due diligence phase on the potential impact that economic changes would have on the business risk of the proposed transaction. In addition the financial models of these business applicants are further stressed for potential scenarios where several economic variables change in order to ascertain the ability of the forecast cash flows to accommodate these changes. Where necessary, funding structures are adjusted in order to provide some lee-way for this business risk to be accommodated.

The risks are updated on a regular basis so that the relevant mitigation plans are put in place as new risks are identified. Mitigation measures are identified and implemented for identified risks and these are tracked at RPMC.

Credit Risk Assessment Process

The credit risk assessment process, which requires all deals submitted for approval to be reviewed by the credit unit as well as the completion of background checking, has been successfully implemented. Due to the success of this unit, it has been given additional capacity.

Portfolio reporting

The monitoring of the invested portfolio is a key focus of the RPMC. A Post-Investment Unit is in place to monitor the portfolio and report to RPMC on the status of the portfolio, examining exposure per industry, risk rating per client and an update on the top 20 exposures and initiatives undertaken by management to manage these exposures.

Committee Membership and Attendance

The membership of the RPMC is as follows:

- Z Ntlangula (Former Chairman and Trustee) *
- R Garach (Trustee)
- A Halstead (Trustee)
- K Thaver (Acting Chairman and Trustee) **

During the year under review, the attendance record of the members of the RPMC was as follows:

Member	19 July 2011	19 October 2011	29 March 2012
Zukiswa Ntlangula (Former Chairman)*	√	√	n/a
Avril Halstead	√	√	√
Rakesh Garach	√	√	√
Kugan Thaver (Acting Chairman) **	n/a	n/a	√

* With effect from 1 November 2011 Ms Ntlangula was appointed as Acting Chairman of the Board of Trustees. As a result of this appointment her attendance at the RPMC was suspended

** Appointed as Acting Chairman on 31 October 2011

Mr Kugan Thaver
Acting Chairman of the Risk and Portfolio Management Committee