Risk management and control

Having regard to the fact that managing risk is an inherent part of the group’s activities, risk management and the ongoing improvement in corresponding control structures remain a key focus of management in building a successful and sustainable business. Within a complex financial services environment, the board recognises that risk management is a dynamic process and that the risk framework should be robust enough to effectively manage and react to change in an efficient and timeous manner.

Peregrine has historically evolved into independent operating units with minority ownership and/or participation by management in each of the group’s subsidiaries.

Formalisation of a risk management framework, as well as the functions of information technology, human resources and treasury are, however, centralised and provided by Peregrine Holdings.

This facilitates:
- efficient allocation of capital across various activities in order to maximise returns and diversification of income streams;
- efficient liquidity management and control of funding costs, and
- improved risk management and control.

Whilst the board is ultimately responsible for the management of risk, the board relies on management to operate within the control structures and frameworks established by the board and has delegated the responsibility for implementation of the risk framework to functions within the operating units. The structure of the group promotes the active participation of executive management in all of the operational and strategic decisions affecting their business units. This creates a strong culture of ownership and accountability.

Senior management takes an active role in the risk management process and is responsible for the implementation, ongoing maintenance of and ultimate compliance with the risk process as it applies to each business unit. The board is kept abreast of developments through formalised reporting structures, ongoing communication with management, regular board meetings at an operating subsidiary level and through representation of executive members of the board on certain of the forums responsible for the management of risk at an operating subsidiary level.

The group remains committed to employing the highest calibre of staff to ensure a strong financial and operational infrastructure within each of the business units.

Risk management structure

The group risk management framework is summarised below. Key responsibilities lie with the following management bodies and committees.

Group board of directors: responsible to shareholders for the strategic direction, supervision and control of the group and for defining the group’s overall tolerance for risk.

Board of directors of subsidiary entities: responsible for the strategic direction, supervision and control of the respective entity and for defining the entity’s tolerance for risk.

Risk committees: responsible for assisting the board of directors of the group and subsidiary entities in fulfilling their oversight responsibilities by providing guidance regarding risk governance and the development of the group’s risk profile, including regular review of major risk exposures and the management of risk limits. Relevant committees are detailed as part of the corporate governance review on page 17.

Audit committees: responsible for assisting the various boards in fulfilling their oversight responsibilities by monitoring management’s approach with respect to financial reporting, internal controls, accounting and legal and regulatory compliance, as more fully detailed on page 16 of the corporate governance review.

Internal auditors: responsible for assisting the boards, audit committees and management in fulfilling their responsibilities by providing an objective and independent evaluation of the effectiveness of internal control, risk management and governance processes.

Key risks

The nature of key risks to which the group is exposed are categorised as follows:

Market risk

Market risk is the potential change in the value of a financial instrument resulting from changes in market conditions.

As a wealth and asset management group, Peregrine’s revenue is dependent on the level of funds under management, as well as the
performance of these funds relative to various benchmarks. The values of these funds fluctuate with market movements. The investment of client funds is managed through structured investment processes. The processes operate within a strong operating control environment, incorporating the procedures as set out below.

In addition, Peregrine’s business model has been to invest a substantial portion of the group’s proprietary capital in the funds managed by Peregrine Capital (Pty) Ltd (“Peregrine Capital”) and Peregrine Investment Managers (Pty) Ltd (“PIM”). The group is exposed to market risk as a result of these investments. The group also has exposure to listed and unlisted investments as part of its private equity activities and, through Peregrine Equities (Pty) Ltd (“Peregrine Equities”), has market exposure as a result of certain transactions undertaken as part of its stockbroking activities.

Investment into hedge funds

The group’s investment into hedge funds is part of a capital allocation decision made at a Holdings level. To date, the group has successfully invested funds with Peregrine Capital and, on a smaller scale, the group has invested into certain of the funds managed by PIM.

Peregrine Capital manages a suite of hedge funds, which focus on South African listed equity counters. Stock selection is primarily bottom up, based on fundamental research employing disciplined and consistent research procedures. The funds aim to achieve positive returns regardless of the direction of the equity market.

The group is seeking to expand on the success achieved by Peregrine Capital by taking equity stakes in or entering into profit-sharing arrangements with other single-strategy managers across various hedge fund styles. This initiative is being conducted under the auspices of PIM. Seven single-strategy funds are currently operational within PIM. The group has provided the necessary capital to seed the establishment of certain of these funds and, at year end, was invested in four of the funds.

Whilst part of the group’s strategy to grow its hedge fund business, the decision to fund investments, and the quantum thereof, forms part of the group’s capital allocation decision reviewed by the board and implemented and managed by the Holdings’ executive. Funds are subject to appropriate due diligence and selected on the basis of management’s track record and experience, their approach to investment and risk management, as well as their ability to demonstrate sound operational procedures and acceptable legal infrastructure. Investment into the funds is on an arms length basis within a fund format. Operational controls surrounding the investment process include:

• management according to a fund mandate, which sets out investment parameters including target investments, maximum holdings and exposures, and various investment limits;
• controlled investment processes as determined by the fund manager;
• investor review by way of daily access to portfolio information and regular reporting;
• monitoring of real time positions against mandate limits;
• utilisation of external administrators for the provision of independent accounting, administration and valuation services, and
• annual audit of the funds by the group’s independent auditors.

Peregrine measures the profit/loss of its proprietary investment portfolio monthly or more regularly if required and has the ability to exit investments on a quarterly basis. As all of the funds in which the group has invested to date are managed in-house, Peregrine has access to detailed portfolio composition, risk reports and the ability to review underlying investment decisions of the fund manager. The risk management process surrounding the funds is viewed as fundamental and primary to the long-term success of the funds.

Investments held as part of the group’s private equity activities

The group’s private equity investments are accounted for on balance sheet and funded by the group’s free cash flow. Investment decisions are within a fund mandate, approved by the board and implemented and managed as part of management of the group’s balance sheet. The mandate prescribes overall private equity exposure as a proportion of the group’s investable assets and limits exposure to individual investments and investment types. Positions are revalued at current market prices on a semi-annual basis.

Investments held as part of the group’s stockbroking activities

As part of the service offering of Peregrine Equities, the company has entered into structured transactions with institutional and hedge fund clients and over the course of the financial year under review with a growing number of select private clients, involving a combination of stock, option, contract-for-difference (“CFD”) and collateral
Within the Peregrine group, credit risk does not include the risk inherent in traditional banking business, as the group is not in the business of lending money.

Peregrine’s exposure to credit risk is limited to the risk inherent in its private equity activities and to risks involved in the facilitation of, and participation in, structured equity transactions undertaken within the stockbroking business.

The group’s most significant exposure to credit risk is as a result of CFD transactions undertaken within Peregrine Equities. The credit risk inherent in these transactions is managed primarily through structured initial and variation margin requirements, in addition to the control structures detailed under the heading of market risk.

Within the area of private equity, risk is managed via contractual protections, ensuring a close and ongoing relationship with the entity and by managing exposure within the context of shareholding and control structures. Overall exposure to private equity is limited through mandate limits approved by the Holdings board.

Liquidity and interest rate risk

Liquidity risk refers to the ability to meet funding obligations as they fall due. The group’s treasury function is centralised, thus ensuring that capital is appropriately allocated across the group and that funding and commitments are met timeously. Interest rate risk refers to the impact of interest rate repricing on future cash flows and earnings of assets and liabilities.

As the group is not involved in deposit taking and lending activities the group is not exposed to liquidity risks associated with the matching of asset and liability maturities as within a traditional banking environment.

The group has the ability to borrow internally against several of its hedge fund investments and has appropriate external funding facilities in place. The group has the ability to draw down on hedge fund investments on a quarterly basis.

Within the stockbroking business, liquidity is managed through the appropriate capitalisation of Peregrine Equities, treasury management at the operations level and by ensuring that business growth is within the constraints of available credit lines and existing capital resources.

Risk management and control

positions. Growth in the CFD book has been a significant factor in the increased profitability of the structuring, broking and distribution division, which almost doubled its contribution to group profitability to 26% compared to 14% in the previous financial year. Relevant scrip lending and International Swap Dealers Association (“ISDA”) agreements cover all positions.

The instruments underlying CFD, option and futures contracts are equity securities listed on the JSE Limited. The contracts are hedged via a position in the underlying listed equity. Contracts are subject to initial and daily variation margining arising out of the marking-to-market of the underlying equity security. Peregrine Equities’ exposure to market risk is thus indirect and arises as a secondary exposure in the event of a client’s inability to meet margin payments.

The group manages this exposure through:

• appropriate initial and daily variation margin requirements;
• setting of internal limits on the net exposure per security per client, and across the CFD book based on the liquidity of the underlying security;
• an internal credit rating applied to different clients;
• real time review of exposures by client and relative to margin held;
• scenario analyses that estimate the maximum exposure that may arise under various market conditions, and
• the implementation of appropriate procedures to ensure that the business is able to respond quickly and effectively when corrective action needs to be taken.

Credit risk

Credit risk is the risk of loss resulting from the default of a counterparty. Credit risk includes settlement risk.

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Reputational risk
As a manager of substantial third party assets, the group is highly cognisant of the importance of its reputation to both existing and potential clients. The sustainability and growth of the business relies on the group’s ability to maintain a reputation of integrity and professionalism. Consideration is thus given, at all levels, to the mitigation of risks which may cause reputational damage. In this regard, a comprehensive process is followed prior to entering into any new arrangement with an outside party for the purpose of managing third party assets.

Strong cash flow generation over the course of the year has facilitated the repayment of internal borrowings and limited the requirement to utilise external facilities. The decision to gear against certain of the group’s newer hedge fund investments is a result of enhanced return rather than liquidity considerations.

Assets and liabilities sensitive to interest rate movements are detailed in Annexure C of the financial statements. Interest earned as part of the group’s stockbroking activities is vulnerable to declines in interest rates, as well as to declines in market activity as interest on funding and collateral is accrued and paid at variable rates linked to a lending or deposit rate.

Compliance risk
Compliance risk is the risk of non-compliance with statute, including regulations imposed by the South African Reserve Bank, the Financial Services Board and various other financial exchanges. The group has employed and allocated skilled staff to specific compliance functions as part of its risk management framework. The monitoring and management of compliance risk is reported on to the audit and applicable risk committees.

With the growth in the hedge fund industry locally, changes in the regulatory environment are inevitable. As a leading participant in the South African market, Peregrine will continue to manage its businesses in line with changes in the industry and in the best interests of the group and its clients.

Operational risk
Operational risk is the risk of direct or indirect loss as a result of a breakdown in systems, communications or internal processes. Key risk areas include those related to transaction processing, information technology and legal.

Operational risk is managed through a comprehensive system of internal controls as well as sound practices in the areas of human resources and information technology. The group’s internal auditors play a role in reviewing the effectiveness of the control systems in place and in ensuring that procedures are adapted to address control weaknesses. In addition, appropriate professional indemnity and related insurance cover extends to all areas in the group.