Financing and risk

This section describes the treasury, funding and liquidity management activities undertaken by GKN. It also summarises the financial and non-financial risks which GKN faces in its global operations.

Jayne Dore (left) and Helen Watton of GKN's treasury function in the UK studying foreign exchange trends. The global nature of GKN's operations means that its treasury specialists play a key role in managing the Group's foreign exchange risks and exposure.

Financing

Treasury management

GKN co-ordinates all treasury activities through a central function the purpose of which is to manage the financial risks of the Group as described below and to secure short and long-term funding at the minimum cost to the Group. The central treasury function operates within a framework of clearly defined Board-approved policies and procedures, including permissible funding and hedging instruments, exposure limits and a system of authorities for the approval and execution of transactions. It operates on a cost centre basis and is not permitted to make use of financial instruments or other derivatives other than to hedge identified exposures of the Group. Speculative use of such instruments or derivatives is not permitted.

The central treasury function prepares a formal twice yearly report to the Board, as well as formal monthly reports for the Finance Director and other senior executives of the Group. In addition liquidity, interest rate, currency and other financial risk exposures are monitored daily and the gross and net indebtedness of the Group is reported on a weekly basis to the Chief Executive and the Finance Director. The central treasury function is subject to an annual internal and external review of controls.

Funding and liquidity

The Group funds its operations through a mixture of retained earnings and borrowing facilities, including bank and capital markets borrowings and leasing. The relative proportions of equity and borrowings are governed by specific Board-approved parameters. These are designed to preserve prudent financial ratios, including interest, dividend and cash flow cover, whilst also minimising the overall weighted average cost of capital to the Group.

All the Group's borrowing facilities are arranged by the central treasury function and the funds raised are then lent to operating subsidiaries on commercial arm's length terms. In some cases operating subsidiaries have external borrowings, but these are supervised and controlled centrally. The Group's objective is to maintain a balance between continuity of funding and flexibility through borrowing at a range of maturities from both capital markets and bank sources. Bank borrowings are principally in the form of five year committed multi-currency bilateral revolving credit facilities that mature in 2010 with a group of relationship banks. There were no borrowings against these facilities as at 31 December 2006.

Capital market borrowings of £705 million include unsecured issues of £350 million 6.75% bonds maturing in 2019 and £325 million 7% bonds maturing in 2012, together with £30 million debenture stock of Westland Group plc, maturing in 2008, which is secured on assets of that company and certain of its subsidiaries.

At the year-end the Group had committed borrowing facilities of £1,085 million, of which £735 million was drawn. The weighted average maturity profile of the Group's committed borrowings was 8.8 years. This leaves the Group well placed to fund its strategic growth plans and to withstand any sudden changes in liquidity in the financial markets.

The Group also has access to significant lines of uncommitted funds which are used principally to manage day-to-day liquidity. Wherever practicable, pooling, netting or concentration techniques are employed to minimise gross debt.

At the year-end the Group had £163 million on deposit in the UK mainly held in money market funds or with banks at maturities of three months or less.

Financial resources and going concern

At 31 December 2006 the Group had net borrowings of £426 million. In addition it had available, but undrawn, committed borrowing facilities totalling £350 million.

Having assessed the future funding requirements of the Group and the Company, the Directors are of the opinion that it is appropriate for the accounts to be prepared on a going concern basis.

Risk

Financial risk

The Group is exposed to a variety of market risks, including the effects of changes in foreign currency exchange rates and interest rates. In the normal course of business, the Group also faces risks that are either non-financial or non-quantifiable, including country and credit risk.

The Group uses interest rate swaps, swaptions, forward rate agreements, netting techniques and forward exchange contracts as required to manage the primary market exposures associated with its underlying assets, liabilities and anticipated transactions.

Counterparty credit risk

The Group is exposed to credit-related losses in the event of non-performance by counterparties to financial instruments. Credit risk is mitigated by the Group's policy of only selecting counterparties with a strong investment graded long-term credit rating, normally at least AA– or equivalent, and assigning financial limits to individual counterparties.

Interest rate risk

The Group operates an interest rate policy designed to optimise interest cost and reduce volatility in reported earnings. This policy is achieved by maintaining a target range of fixed and floating rate debt for discrete annual periods, over a defined time horizon. This is achieved partly through the fixed rate character of the underlying debt instrument, and partly through the use of straightforward derivatives (forward rate agreements, interest rate swaps and swaptions). The Group's normal policy is to require interest rates to be fixed for 30% to 70% of the level of underlying borrowings forecast to arise over a 12-month horizon. However, this policy was suspended in December 2004 as it was deemed inappropriate given the absence of floating rate bank debt following the receipt of the sale proceeds of GKN's share in AgustaWestland. Consequently, as at 31 December 2006, 91% of the Group's gross financial liabilities were at fixed rates of interest, whilst the weighted average period in respect of which interest has been fixed was 8.9 years.

Currency risk
The Group has transactional currency exposures arising from sales or purchases by operating subsidiaries in currencies other than the subsidiaries' functional currency. Under the Group's foreign exchange policy, such transaction exposures are hedged once they are known, mainly through the use of forward foreign exchange contracts. The Group has a significant investment in overseas operations, particularly in continental Europe and the Americas. As a result, the sterling value of the Group's balance sheet can be affected by movements in exchange rates. The Group therefore seeks to mitigate the effect of these translational currency exposures by matching the net investment in overseas operations with borrowings denominated in their functional currencies, except where significant adverse interest differentials or other factors would render the cost of such hedging activity uneconomic. This is achieved by borrowing either directly (in either the local domestic or euro-currency markets), or indirectly through the use of rolling annual forward foreign exchange contracts. Borrowings created through the use of such contracts amounted to £699 million at 31 December 2006 and were denominated in US dollars (44%), euro (45%) and Japanese yen (11%).

In addition to the inherent specific financial risks and their management referred to above, there are other, more general, financial risks that could have a material adverse effect on our business, financial condition, or results of operations.

Pension and retiree medical risk
We operate both defined benefit (DB) and defined contribution (DC) pension plans, together with retiree medical arrangements. The majority of the DB plans are in the UK, North America and continental Europe. Retiree medical arrangements are limited to North America and the UK, where there is a closed scheme. In total, the DB pension and retiree medical schemes were in deficit by £561 million as at 31 December 2006. Deterioration in asset prices, changes to real long-term interest rates or the strengthening of longevity assumptions could lead to an increase in the deficit or give rise to an additional funding requirement.

Taxation risk
The Group operates in many countries and as a consequence is subject to many tax laws and administrative procedures. Many of these rules are complex and subject to detailed scrutiny by tax authorities undertaking audits and ultimately litigation which may take several years to complete. Against this background significant management judgement is taken in arriving at the estimate of income tax due in each jurisdiction in which the Group operates.

Amounts accrued and provided for income tax liabilities are based upon management's judgement taking into account their interpretation of tax law in each country and the likelihood of settlement where there is a tax dispute. However, actual tax liabilities could differ from the provisions made by management and the difference would give rise to an adjustment in a subsequent period which could have a material impact on the Group's profit and loss and/or cash position.

Other risks and uncertainties

Our business is exposed to a number of other risks and uncertainties.

As part of the Group's risk management process each business assesses the likelihood and potential impact of a range of events in the light of their current circumstances and processes, to determine the overall risk level and to identify actions necessary to mitigate their impact. A detailed description of the Group's procedures to manage risk is given in the corporate governance statement.

This section highlights those business risks not discussed above which could have a material impact on our future financial performance and cause results to differ materially from expected and historical results. Additional risks not currently known or which are regarded as immaterial could also affect future performance.

Market and customer related risk
Global economic and political risk
GKN operates in over 30 countries including several in the emerging markets of Asia Pacific and Latin America. We are, therefore, exposed to a wide range of risks including political, regulatory, environmental and socio-economic factors but are also in a position to benefit from significant growth opportunities and a diversified business base.

Cyclical nature of the markets in which we operate
Approximately 61% of our 2006 sales were for automotive vehicle manufacturers and 16% for original equipment on aircraft or aircraft components.

The automotive industry, in common with other capital goods industries, is affected by macro-economic conditions and consumer demand and preferences. The military aircraft element of our business is affected by political considerations, particularly in the USA, whilst civil demand is affected by the number of passenger miles flown which, in turn, is a function of economic growth and personal spending power and perceived security risk.

Customer concentration and relationships
The Group receives approximately 50% of its sales revenue from 11 major global customers. The loss of or damage to any of these relationships or a significant worsening of commercial terms with these customers could have a material impact on the Group's results.

At the same time there is a significant benefit from trading with customers of this nature and considerable resource is devoted to ensure that satisfactory relationships are maintained and developed.

Credit risk
With the concentration of customers noted above the financial failure of any one of them could have a material impact on results. The Group closely monitors credit exposures which are reported to divisional management, and overall divisional performance is reviewed regularly by the Executive Committee. At 31 December 2006 the largest individual debtor balance was 1.0% of Group sales.

Technological change
The markets for our products and services are characterised by evolutionary change driven by consumer preference for increased safety and environmentally friendly motor vehicles and aircraft. We ensure that we are responsive to this by substantial investment in technological development in all businesses.

Manufacturing and operational risk
Manufacturing strategy
Strategies are developed with the objective of aligning production with the lowest available cost base. Failure to meet customer requirements as these are implemented would impact upon both short and longer term customer relationships. We have considerable experience of implementing operational change and a wealth of experience to draw on to minimise this risk.

Product quality and liability
The nature of our products mean that we face an inherent risk of product liability claims if failure results in any claim for injury or consequential loss. However, our customers require high levels of quality assurance and manufacturing systems in place to ensure that our quality record is world class in both Automotive and Aerospace. Appropriate levels of insurance are in place covering product liability of third parties although the Group does not generally insure against the cost of product warranty or recall.

Supply chain
Our manufacturing processes may have dependencies on the availability of specific equipment and raw materials. An inability to supply because of their non-availability would affect our sales and relationships with our customers. Contingency plans exist to ensure continuity of supply, though in most cases this would result in additional costs which may or may not be recoverable through insurance.

IT systems reliability, security and change
Our IT systems and networks are secured by formalised back up systems, hardware, virus protection and other measures but any interruption could lead to disruption in service. A breakdown of security or damage arising from any cause could affect our operational performance or revenue.

Technology risk
Many of the Group's products are technologically advanced or use technologically advanced processes in their manufacture and continuous improvement takes place as new technology is developed. If we do not keep up with technology changes our products will no longer be competitive. We therefore make substantial investment in research and development to maintain or achieve technological leadership in our key businesses and retain the competitive advantage which such leadership gives.

Environmental risk
The environmental laws of various countries impose obligations on our businesses to operate in an environmentally friendly way. Failure to do so would result not only in financial consequences but also in damage to our reputation and may impact shareholder value as well as our employees and communities in which we operate. In environmental terms, our manufacturing processes are not inherently high risk, nevertheless great care is taken to prevent any adverse impact arising.

Insurance
The Group insures against the impact of a range of unpredicted losses whether associated with business assets such as buildings, plant, machinery and ensuing financial impact arising from interruption to the business, as well as its liabilities (whether statutory or not) in connection with employees, products supplied or the public at large. This insurance takes the form of a significant level of capped self insured retention at the Group level (within GKN's own captive insurance company, Ipsley Insurance Ltd, which does not insure the risks of any other entity) and a much lower level of self insurance at the subsidiary level. Catastrophe insurance is then purchased in the commercial market over and above this level of self insured retention. Ipsley's current participation in GKN's insurance programme is £10 million each incident capped at £20 million in any one year.