Identification & Assessment of Risks 2018

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Risk Management for the Microfinance Sector (2018)

Identification & Assessment of Risks

1) Risk Register Tool – An Introduction

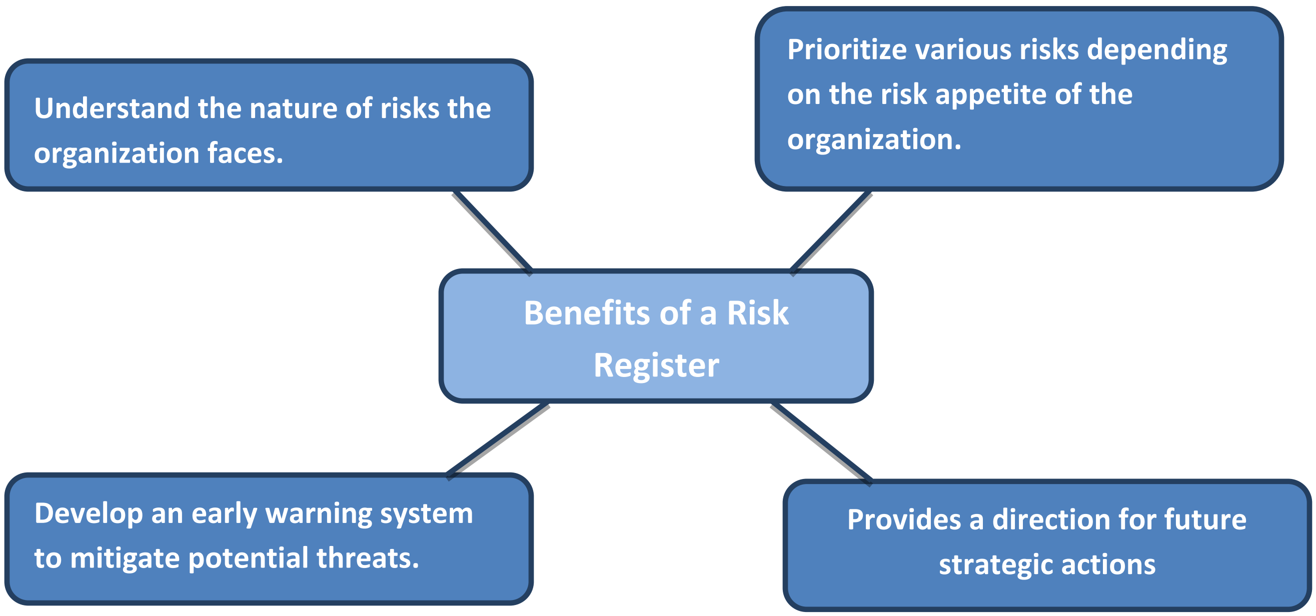
Risk is an inherent element of financial services, and like all financial institutions, microfinance providers (MFPs) face risks that they must manage effectively to achieve their financial and social objectives. It is imperative for microfinance providers to have a formal risk management structure in place to proactively establish processes that support business objectives while mitigating risks to an acceptable level.

The Pakistan Microfinance Network (PMN) has taken constructive steps to promote sound risk management practices amongst microfinance practitioners across Pakistan. As part of PMN's long term strategy to achieve sustainable growth in the Pakistan microfinance sector, PMN had launched the first Risk Register for the microfinance sector in Pakistan in 2016 (Figure 1).

A risk register is a tool widely used by organizations for the identification and assessment of risks. The tool is considered a vital component of the risk management process as it serves as a central source for the organization's risk information and acts as a risk directory. It is used by organizations to list various risks, specifying the probability of occurrence and severity of impact, along with possible risk mitigation steps and strategies.

While the need for risk management has been identified as a priority by most MFPs for quite some time, the establishment of a risk management function is new in many organizations. PMN believes such a tool will enable MFPs (especially those with no existing risk management structures in place) to understand the nature of risks faced by the organizations at strategic and operational levels. The Risk Register will provide management and key stakeholders with significant information on diverse threats, which can be utilized to design risk management strategies to mitigate potential threats.

Figure 1: Risk Register

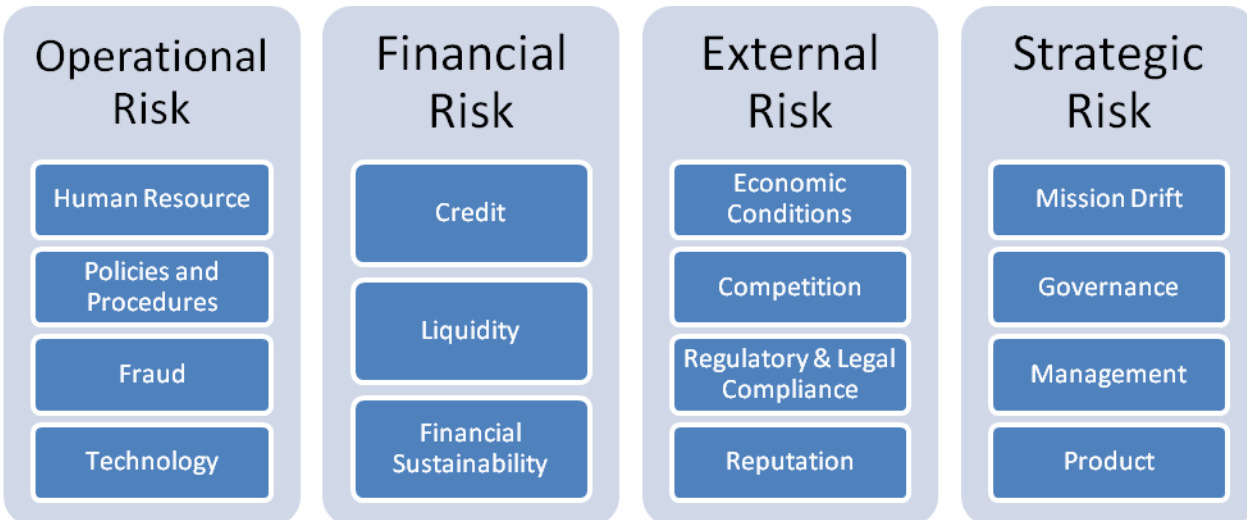


	Risk Statement	Probability of Impact	Severity of Impact	Existing Controls	Effectiveness of Controls	Planned Future Actions	Implementation Timeline
A	**Operational Risk**						
(i)	**Human Resource Risk**						
a	Hiring and Verification						
b	Training & Development						
c	Employee Retention						
(ii)	**Policies & Procedures**						
(iii)	**Fraud Risk**						
a	Field Staff						
b	Embezzlement						
(iii)	**Technology**						
a	Sophistication						
b	Integration						
c	Disaster Recovery						
B	**External Risk**						
(i)	**Economic Conditions**						
a	Security						
b	Interest Rate						
c	Natural Disaster						
(ii)	**Competition**						
(iii)	**Regulatory & Legal Compliance Risk**						
(iv)	**Reputation Risk**						
C	**Financial Risk**						
(i)	**Credit Risk**						
a	Due Diligence & Appraisal						
b	Monitoring/Recovery						
(ii)	**Liquidity Risk**						
(iii)	**Financial Sustainability**						
D	**Strategic Risk**						
(i)	**Mission Drift**						
(ii)	**Governance**						
a	Board of Directors						
b	Oversight						
(iii)	**Management**						
(iv)	**Product Risk**						

2) Structure of the Risk Register

The Risk Register focuses on four broad risk categories: Operational Risk, Financial Risk, External Risk and Strategic Risk. For each major risk category, the template further includes specific risk sub-categories as depicted in Figure 2.1:

Figure 2.1: Risk Sub-Categories



The potential threat faced by an institute from each sub-subcategory of risk is determined by the severity and probability of impact. Both measures are a vital component of the Risk Register, (shown in Figure 1), and are calculated by a combination of quantitative and qualitative risk indicators

For example, while computing financial risk, an MFP will have to measure the severity and probability of impact of each risk sub-category (credit, liquidity, and financial sustainability) for the organization.

This is achieved by measuring institutional attributes against a set of carefully drafted risk indicators unique to each sub-category. Figure 2.2 highlights the risk indicators used in the risk register to determine the severity and probability of *liquidity risk*.

The risk indicators used for each sub-category have been structured keeping in view global best practices and regulatory requirements pertaining to risk management, along with constructive input from industry practitioners.

<u>Probability of Impact</u>
The chances of suffering the consequences of the event, at any moment or over time.

<u>Severity of Impact</u>
The level of potential consequences of the event, at any moment or over time

Figure 2.2: Measurement of Liquidity Risk

	PROBABILITY	Answer	Explanation	Risk Meter
1	Does the MFP have a formal set of policies to manage liquidity risk?	No		5
2	How frequently does the Asset Liability Committee (ALCO) review the liquidity position of the organization?	Quarterly		1
3	Does the MFP conduct a cash flow analysis/projection to monitor liquidity gaps?	Yes monthly		1
4	Does the MIS system of the organization have the capacity to calculate liquidity positions?	No		2
5	For funding purposes, the MFP has a working relationship with how many financial institutions?	Two or Three		1
6	Has the MFP ever been late or defaulted on its debt repayments?	None		0
7	The top management monitors and sets minimum limits on liquid assets?	None		2
8	Percentage of branches in which cash float is determined daily?	60% to 80%		1
9	The trend in PAR > 30 days over the last 12 months?	Stable		1
				78%
	SEVERITY	**Answer**	**Explanation**	**Risk Meter**
1	What percentage of total funding is expected to mature within the next 12 months?	Greater than 70%		3
2	What is the Current Ratio (Assets maturing in less than one year/Liabilities maturing in less than one year) of the MFP?	Less than 1		0
3	What is the Debt Ratio of the MFP (Total debt/Total assets)?	Less than 40%		0
4	Does the MFP have a contingency funding plan in place in case of liquidity crises?	Yes		0
				38%

Risk Meter	< 30%	30% - 60%	> 60%
Impact	Low	Medium	High

3) Purpose & Outcome

3.1) Objective of the Risk Register:

The development and distribution of the risk register to PMN members is based on a twofold objective:

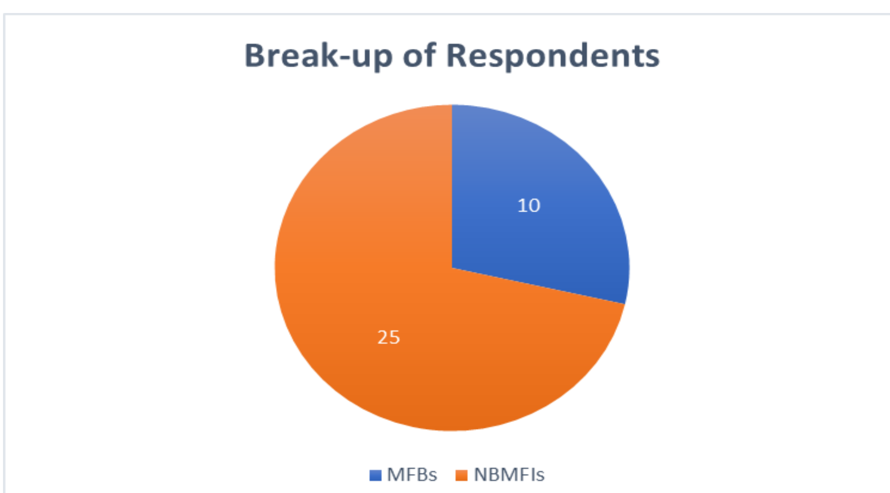
1. to encourage member organizations to use the Risk Register as an internal tool to strengthen their risk management function; and
2. to allow PMN to consolidate the data received from members through the template to create a sector-wide mapping of risks.

The consolidated information is utilized to formulate a ***Risk Map*** on which different risk categories are visually displayed (details to follow). The unification of risk indicators by PMN provides a holistic view of the sector's footing on risk management as weak and vulnerable areas are easily identifiable, along with emerging and potential threats. This information will prove beneficial while devising sector-wide risk mitigation strategies for long term sustainability and growth.

In terms of institutional strengthening, the Risk Register has the greatest utility for MFPs that are operating in the absence of any formal risk management structure. For such organizations (mostly non-bank MFPs), the tool serves as a stepping stone towards creating an effective risk management processes by facilitating the institutes in the identification and assessment of potential threats. It should be noted that a handful of top-tier microfinance providers have developed their own risk registers tailored to their organizational characteristics and complexities.

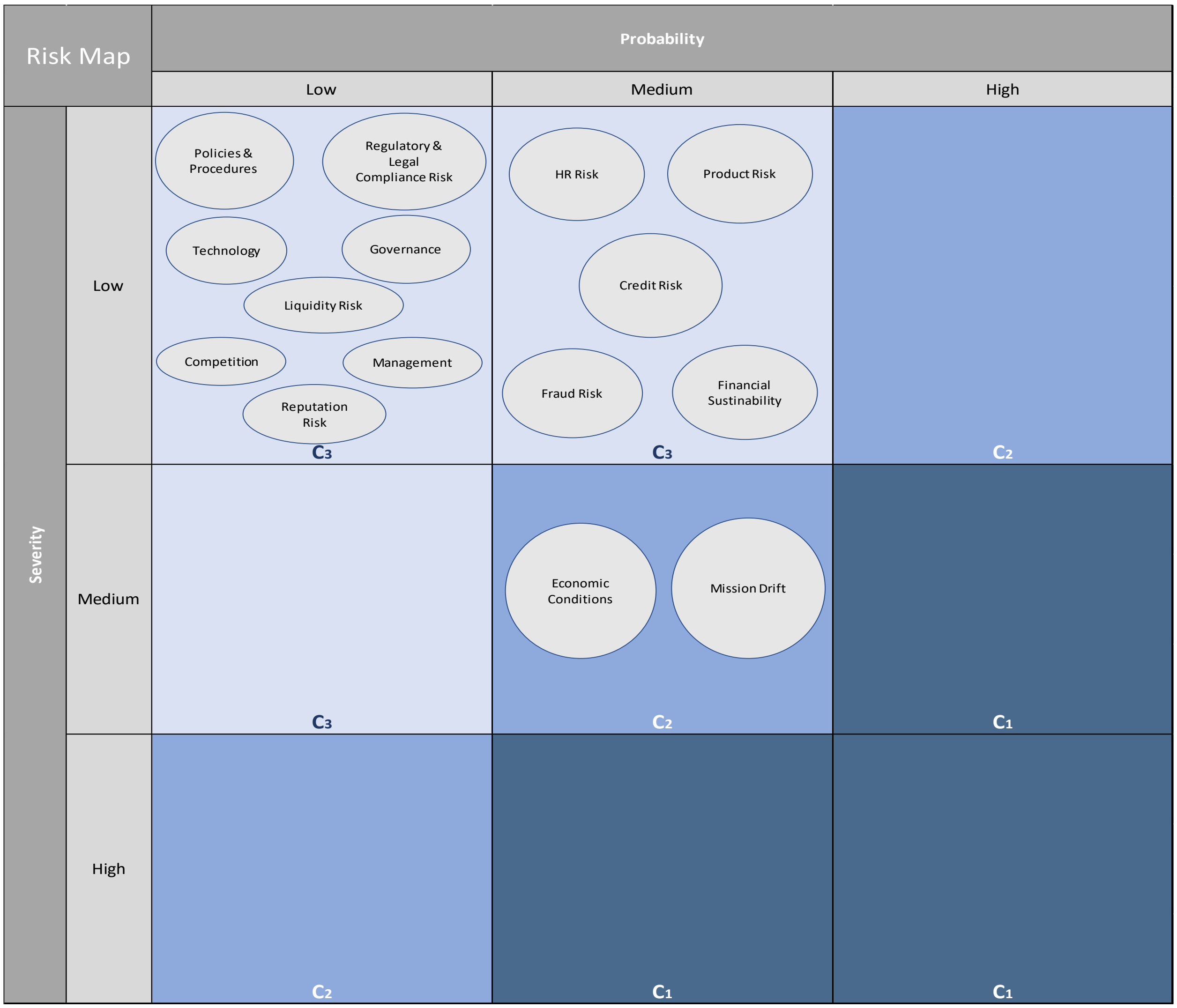
3.2) Mapping of Risk Indicators

The Risk Register was shared with all forty-four members of PMN, of which, thirty-five members provided the completed template to PMN for sector evaluation purposes. Within the thirty-five respondents, ten institutes were Microfinance Banks (MFBs), while the remaining twenty-five institutes were Non-Bank Microfinance Institutes (NBMFIs) (Figure 3.1). However, in the previous year only thirty-one institutes provided the risk register template, out of which six were MFBs while twenty-five were NBMFIs.



The risk indicators (derived from risk registers of the responding MFPs) were combined and plotted on a risk map, depending on their level of criticality. Prior to consolidation, each risk indicator was assigned a weight equivalent to the market share of the specific MFP. The following risk map shows the results of the combined risk registers of the sector.

Figure 3.2: Risk Map of the Microfinance Sector



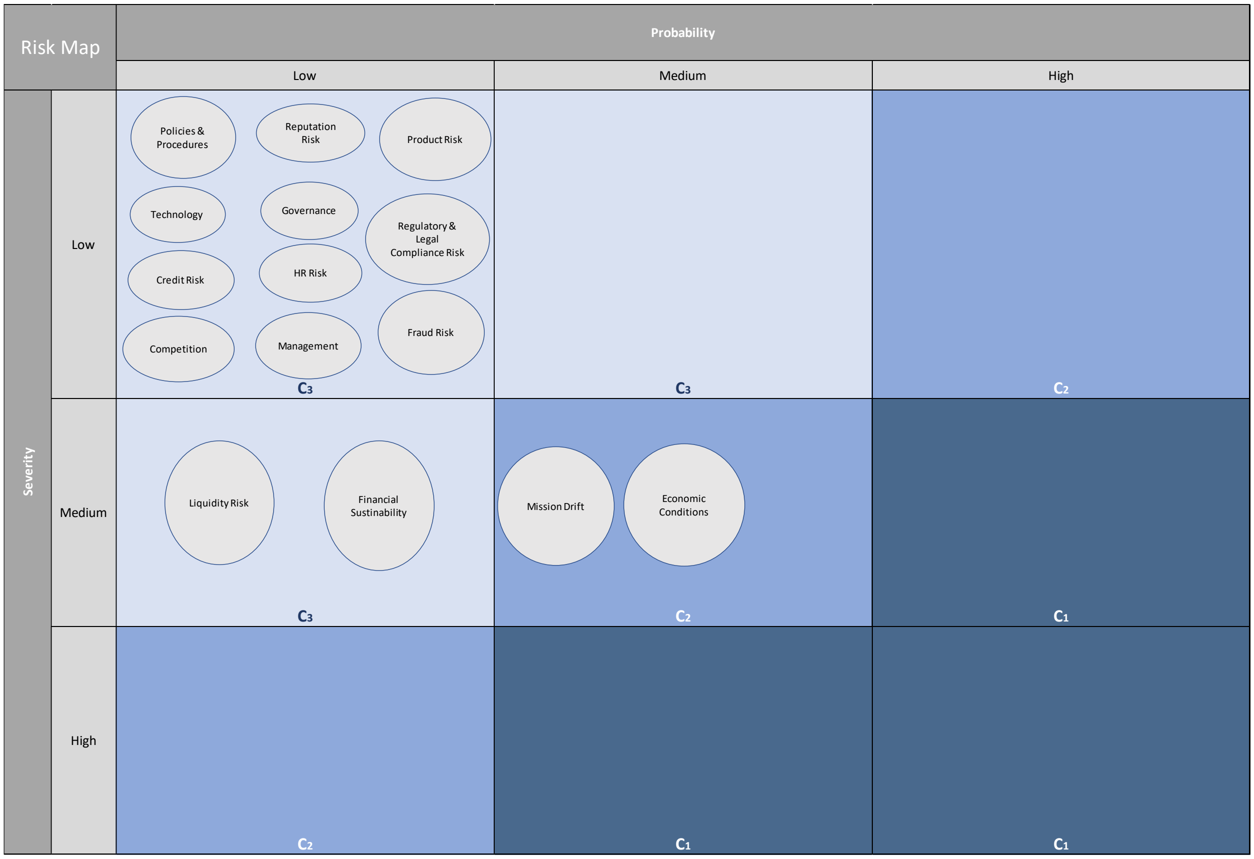
Criticality Level		Risk Responses
C1	High	Actions to reduce the frequency and severity of impact to be identified and implemented at the earliest.
C2	Medium	Actions to reduce the frequency and severity of impact to be identified and implemented appropriately in the near term.
C3	Low	To be kept on watch list – no action is needed unless grading increases over time.

The key findings from the sector risk map are that the risk indicators are essentially distributed in the low and medium category (in terms of level of criticality), of which, majority indicators fall in the low category, which bodes well for the sector.

Compared with the previous Risk Map, it is observed that **Economic Conditions** and **Mission Drift** indicators are the only indicators under Medium Impact, Medium Likelihood category in the current year. **Mission Drift** is the only indicator that experienced an increase in the impact compared to last year. The impact of **HR Risk** decreased in the current year to low, while its probability increased enough to be categorized under the medium category. An increase in the probability of **Fraud Risk, Financial Sustainability** and **Product Risk** was observed. This brought the mentioned indicators under the medium likelihood category on the map. Whereas, **Technology** and **Competition Risks,** both observed a decrease in their likelihood and under the Low Impact, Low Likelihood category. **Liquidity Risk** was the only indicator that experienced a decrease in both Impact and Likelihood, moving from the Medium category to Low category. Moreover, the following indicators: **Economic Conditions, Policies & Procedures, Regulatory & Legal Compliance Risk, Reputation Risk, Credit Risk, Governance Risk and Management Risk** remained unchanged, categorized at low under both impact and probability compared to the previous year.

For a more detailed analysis, the results from the consolidated risk registers were bifurcated into two key peer groups: Microfinance Banks (MFBs) and Non-Bank Microfinance Institutes (NBMFIs). The following two risk maps present the results of each peer group.

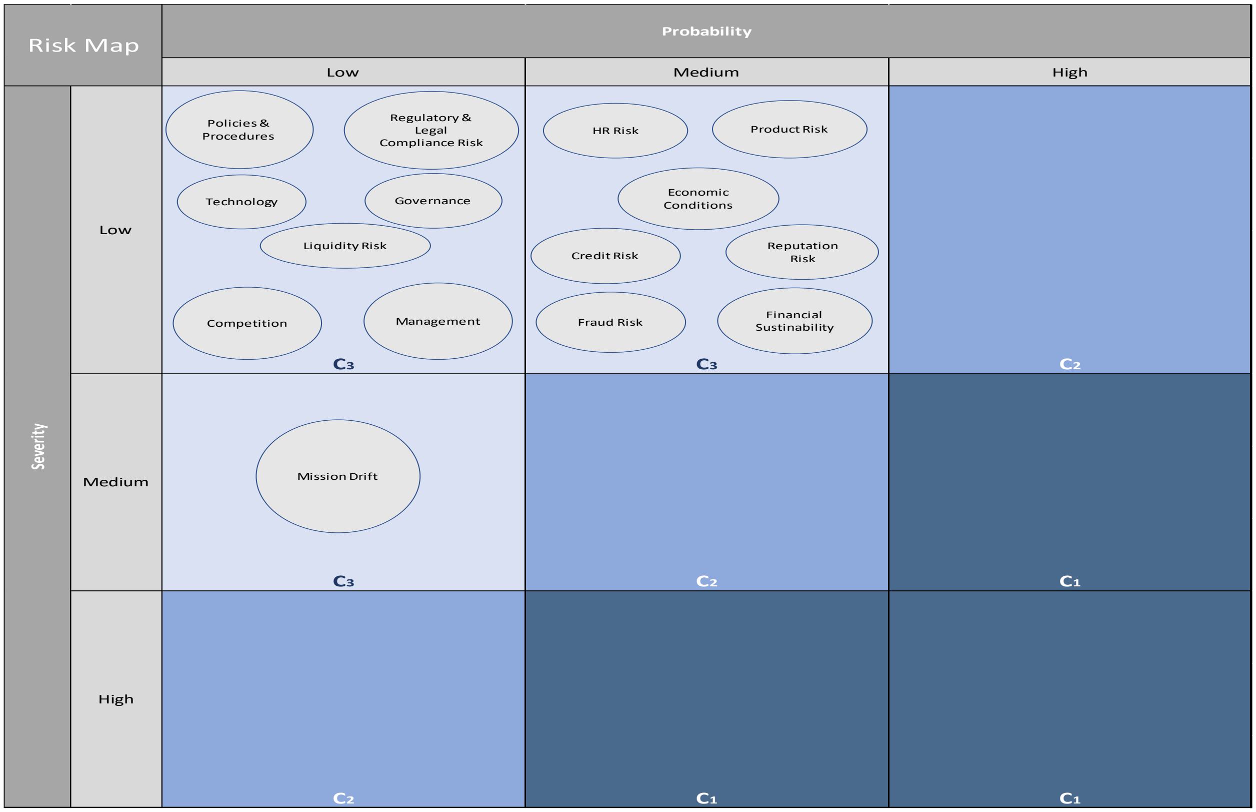
Figure 3.3: Risk Map of Non-bank MFP Peer Group



The Risk Map for NBMFIs indicated that risk arising from **External Economic Conditions** and **Mission Drift** were the greatest threat for most Microfinance institutes and Rural Support Programmes (RSPs). Resultantly, constructive steps need to be taken in the short run to reduce the severity and probability of impact from such risks. Both these indicators fall in the medium criticality category.

Nevertheless, comparison with previous year reveals that NBMFIs have managed to mitigate the likelihoods of risks arising from **Technology, Competition, Liquidity, Financial Stability and Governance** – with all these indicators now falling under the Low Impact and Low Likelihood category apart from **Liquidity and Financial Stability Risks,** falling under the Medium Impact and Low Likelihood category. The remainder of the indicators remained unchanged.

Figure 3.4: Risk Map of MFB Peer Group



The Risk Map for MFBs depicts a slightly different picture; no risk indicator is positioned in the Medium or High criticality category. **Regulatory & Legal Compliance Risk** and **Liquidity Risk** experienced a decrease in severity compared to the previous year – falling under the Low Impact and Low Likelihood category. Risks associated with **Technology** witnessed a decrease in impact and likelihood, moving in the Low Impact and Low Likelihood category. Risks associated with **HR, Fraud, Economic Conditions and Financial Sustainability** witnessed a decrease in impact coupled with an increase in likelihood – falling under the Low Impact and Medium Likelihood category. Risks associated with **Reputation, Credit and Product** faced an increase in Likelihood – falling under Low Impact and Medium Likelihood. Indicators that remained unchanged were **Policies & Procedures, Governance and Management** during the period under review.

4) Future Actions

Going forward, PMN aims to promote the use of the Risk Register by all its member organizations and increase the number of entities reporting for the risk register. Moreover, additional number of risk indicators are to be incorporated so that a more descriptive and deeper understanding of the industry can be achieved.

Based on the findings of the risk register, the perils being faced by the industry shall be discussed at the PMN's Risk Forum for the development of potential risk mitigation strategies. Furthermore, trainings and capacity building exercises for MFPs under PMN's Center of Excellence are to be organized to develop and improve controls that aim to mitigate these risks.

In addition, PMN is aggressively working on setting up an industry wide Disaster Risk Fund. This will assist the players in mitigating risk from natural calamities such as floods, earthquakes and drought. Setting up a disaster risk fund shall allow MFPs to continue working in areas which are disaster prone. Moreover, this initiative would lead players to concentrate on expansion and continued growth in outreach while improving their sustainability.