Identification & Assessment of Risks 2019

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Risk Management for the Microfinance Sector (2019)

Identification & Assessment of Risks

1) Risk Register Tool – An Introduction

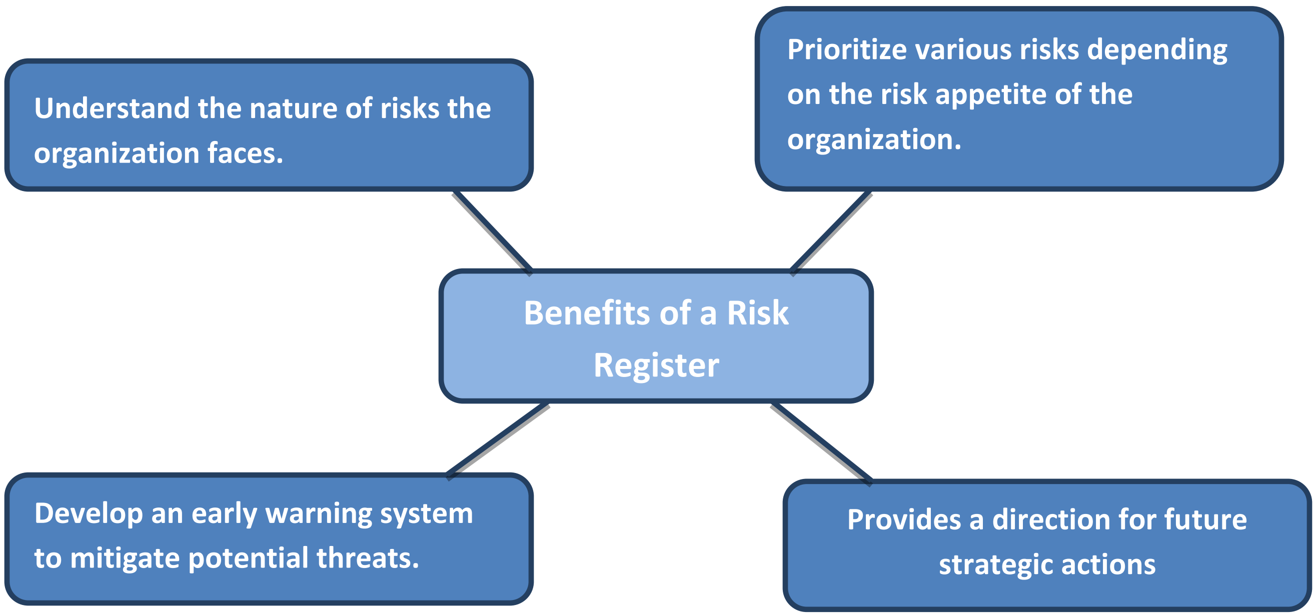
Risk is an inherent element of financial services, and like all financial institutions, microfinance providers (MFPs) face risks that they must manage effectively to achieve their financial and social objectives. It is imperative for microfinance providers to have a formal risk management structure in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

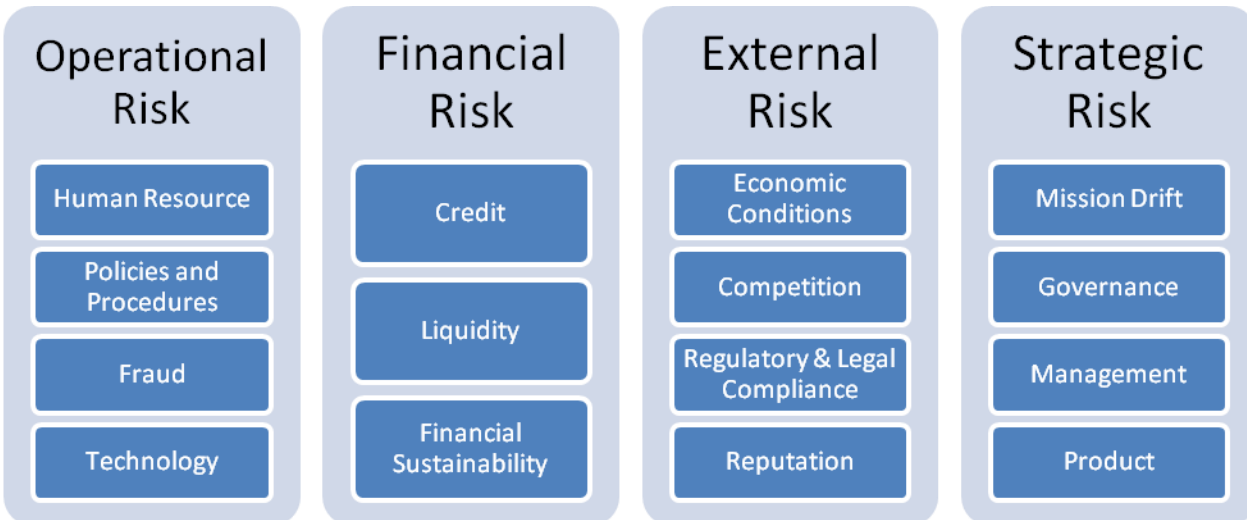


	Risk Statement	Probability of Impact	Severity of Impact	Existing Controls	Effectiveness of Controls	Planned Future Actions	Implementation Timeline
A	**Operational Risk**						
(i)	**Human Resource Risk**						
a	Hiring and Verification						
b	Training & Development						
c	Employee Retention						
(ii)	**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.

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

Severity of Impact
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.

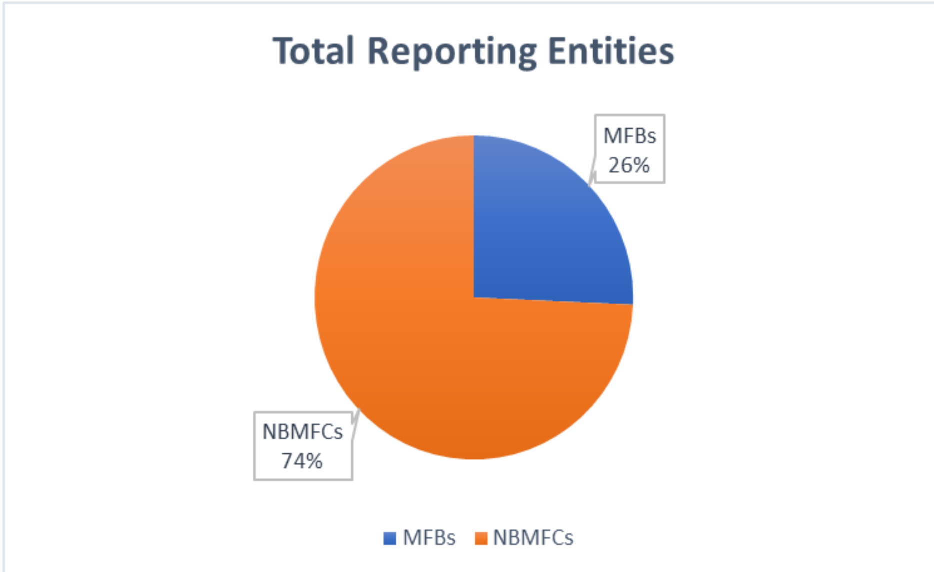
The consolidated information is utilized to formulate a ***Risk Map*** on which different risk categories are visually displayed (details to follow). The unification of risk indicators by PMN provides a holistic view of the sector's footing on risk management as weak and vulnerable areas are easily identifiable, 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, nine institutes were Microfinance Banks (MFBs), while the remaining twenty-six institutes were Non-Bank Microfinance Companies (NBMFCs) (Figure 3.1). In the previous year, the total number of reporting entities were also thirty-five institutes that provided the risk register template, out of which ten were MFBs while twenty-five were NBMFCs.

Figure 3.1: Total Reporting Entities



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

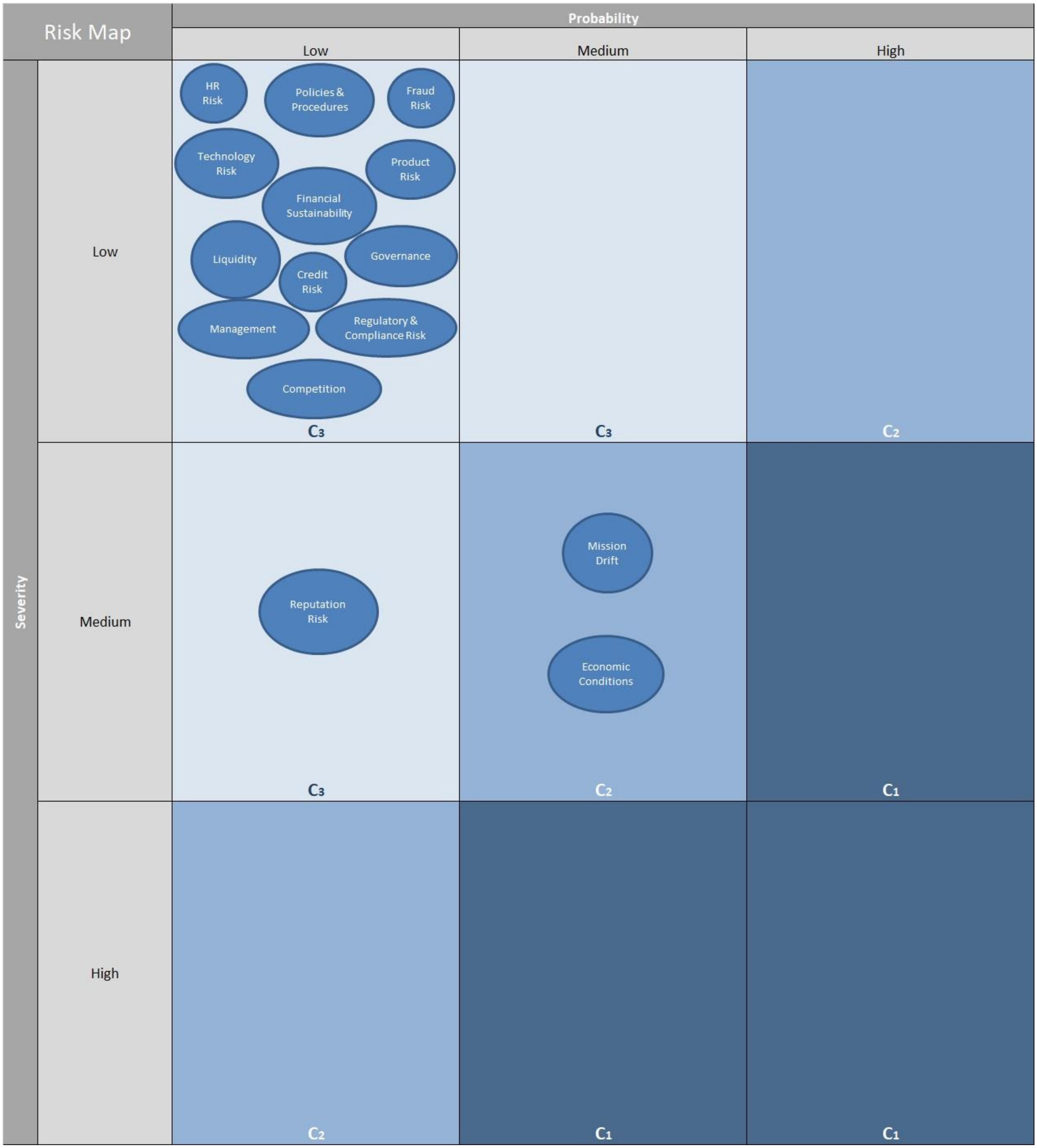
Criticality Level		Risk Responses
C1	**High**	**Actions to reduce the frequency and severity of impact to be identified and implemented at the earliest.**
C2	**Medium**	**Actions to reduce the frequency and severity of impact to be identified and implemented appropriately in the near term.**
C3	**Low**	**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 category (in terms of level of criticality), of which, majority indicators fall in the low severity and probability category, which bodes well for the sector.

Compared with the previous Risk Map, it can be observed that all the indicators have shifted to the low criticality level within the Map. Of the Operational Risks, both **HR Risk** and **Fraud Risk** experienced an Increase in Impact but a decrease in the probability of likelihood which resulted in these risks shifting to Medium Impact and Low Likelihood category. **Credit Risk** also witnessed an increase in Impact while likelihood remained low. **Mission Drift,** which was previously classified as Medium Impact and Medium Probability in the prior year, experienced a decrease in impact, which resulted in it being classified as a Low Impact but Medium Probability Risk. **Economic Conditions, Financial Sustainability** and **Product Risk** experienced a decrease in their respective probability of occurrence, shifting from Medium Criticality to Low Criticality. Moreover, the following indicators: **Policies & Procedures, Technology Risk, Competition Risk, Regulatory & Legal Compliance Risk, Reputation Risk, Liquidity 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 broken down into two key peer groups: Microfinance Banks (MFBs) and Non-Bank Microfinance Companies (NBMFCs). The following two risk maps present the results of each peer group.

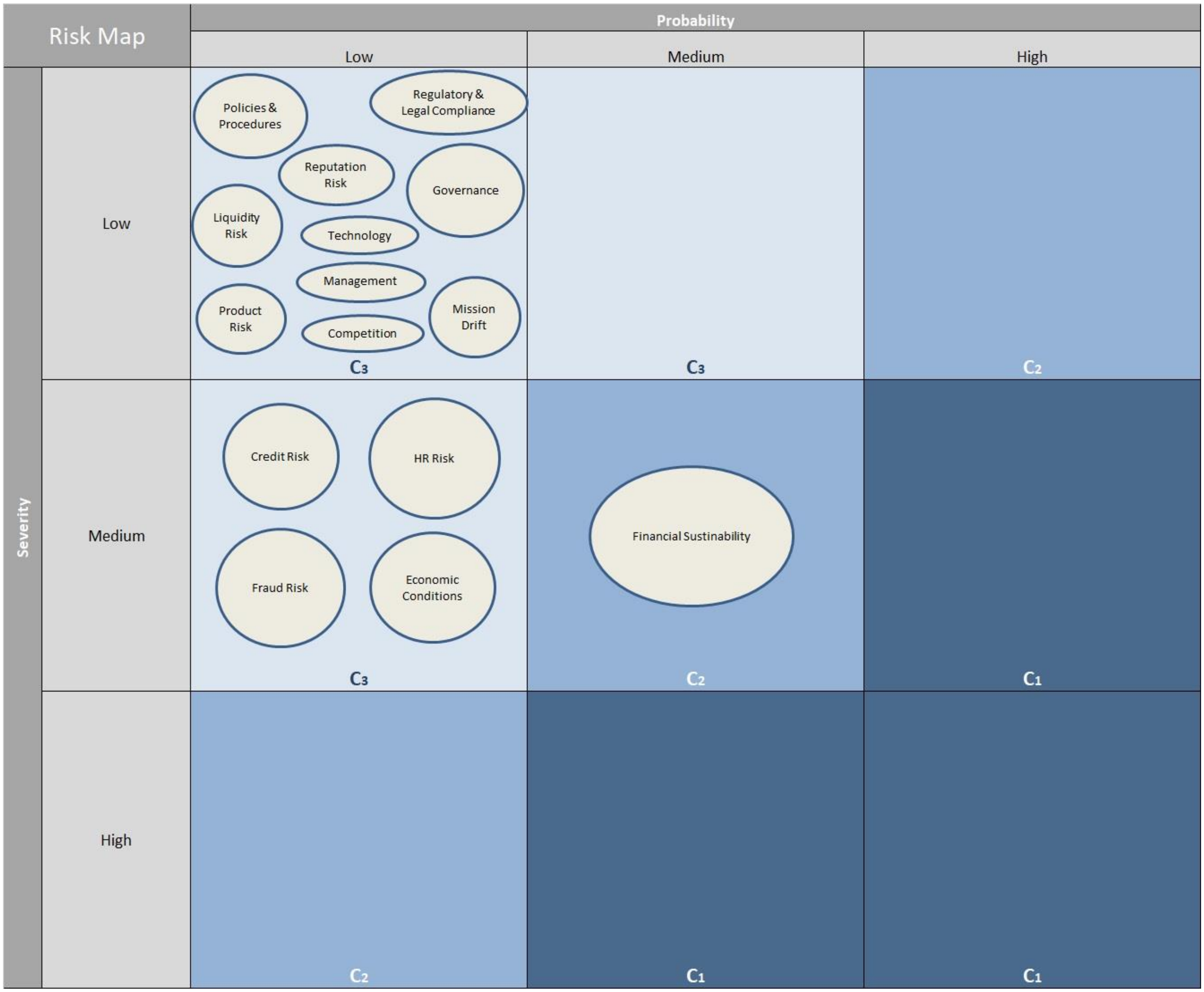
Figure 3.3: Risk Map of NBMFC Peer Group



The Risk Map for NBMFCs indicated that there hasn't been much change compared to the findings in the previous issue of this report. Risks arising from **Economic Conditions** and **Mission Drift** continue to be classified under the Medium Criticality levels. These were the greatest threat for most Microfinance institutes and Rural Support Programmes (RSPs) and fell under the Medium Impact and Medium Likelihood category. **Reputation Risk** is the only risk that experienced an increase in Impact from low to medium while likelihood for the risk remained unchanged. **Liquidity Risk** and **Financial Stability** experienced a decrease in impact from the prior year and are now classified under Low Impact and Low Likelihood.

Overall, the comparison with the previous year reveals that NBMFCs have been successful in managing their risks and mitigating the probability or these risks and their impact to their respective institutes. Their vulnerability to **Economic Conditions** and **Mission Drift** need to be taken into consideration and appropriate measures need to be adopted to counter any adverse effects that may arise from these risks.

Figure 3.4: Risk Map of MFB Peer Group



Observations of the changes in the Risk Map for MFBs depicts that while no risk indicator was positioned in the Medium or High Criticality previously, **Financial Stability** is now the most significant risk that is classified under the Medium Criticality category. With Medium Impact and Likelihood, the risk poses a considerable threat to MFBs and constructive steps need to be taken in order to manage any potential threats arising from this risk. **HR Risk, Fraud Risk, Economic Conditions** and **Credit Risk** also experienced an increase in the severity levels, but the probability of any threats arising from these risks reduced as well. Hence, these are still classified under Low Criticality. The risk of **Mission Drift** experienced a decrease in Impact, while **Reputation Risk** and **Product Risk** experienced a decrease in likelihood. These three risks now fall under the Low Impact and Low Likelihood category of the Matrix.

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.

With concerns on the economic front continuing to persist on the back of rising inflation the sustainability of economic growth is likely to be compromised, which would impact the microfinance sector. This challenge has already had an adverse effect on lenders as they now face obstructions to growth. Additionally, currency risk, commodity price volatility and increasing interest rates have considerably increased the cost of servicing debt. The impact of this risk puts pressure on financial service providers as they cannot pass on their costs to their clients which will diminish the profitability of the industry. Moreover, the clients' ability to repay is also adversely affected due to the prevailing macroeconomic conditions. Such circumstances could result in clients resorting to consumption loans for income smoothing and lead to higher delinquency rates or portfolio at risk.

In addition, internal controls and risk management frameworks need to be continuously updated as the industry evolves. Most importantly, the relationship with the clients' needs to be maintained to keep the practitioners updated about client's financial health & funding needs while also reducing the chances of default.

Based on the findings of the risk register, the issues 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 (CoE) are to be organized to develop and improve controls that aim to mitigate these risks.