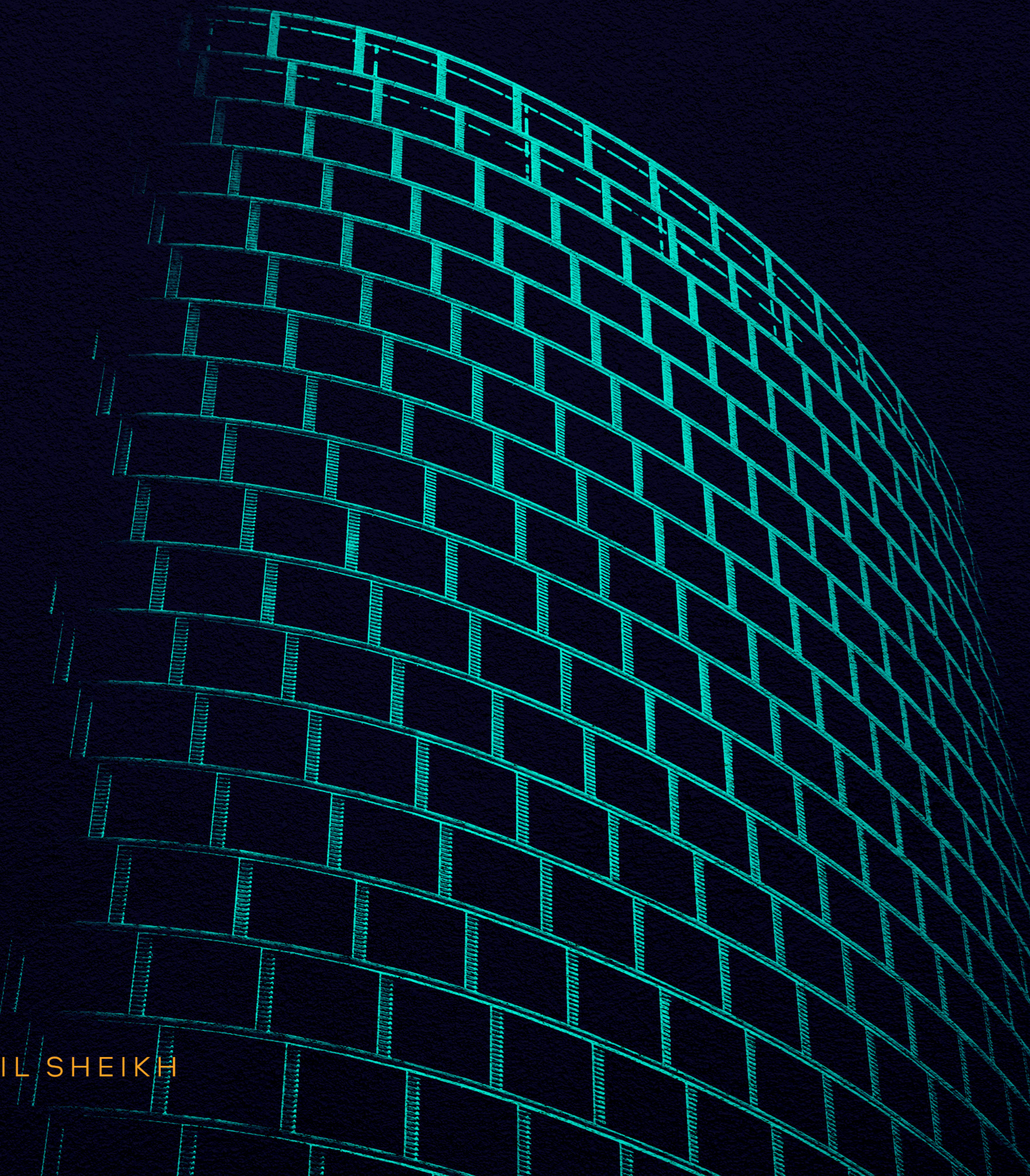
Pakistan Microfinance Network
Achieving Together

IDENTIFICATION & ASSESSMENT OF RISKS 2020

Risk Management for the Microfinance Sector



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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.

BENEFITS OF A RISK REGISTER

Understand the nature of risks the organization faces

Provides a direction for future strategic actions

Prioritize various risks depending on the risk appetite of the organization

Develop an early warning system to mitigate potential threats

Figure 1.1:
Benefits of the Risk Register

Figure 1.2:
Overview of the Risk Register

	Risk Statement	Probability of Impact	Severity of Impact	Existing Controls	Effectiveness of Controls	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:

Operational Risk
Human Resource
Policies and Procedures
Fraud
Technology

Financial Risk
Credit
Liquidity
Financial Sustainability

Strategic Risk
Mission Drift
Governance
Management
Prodcut

External Risk
Economic Conditions
Competition
Regulatory & Legal Compliance
Reputation

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.

SEVERITY OF IMPACT

The level of potential consequences of the event, at any moment or over time.

PROBABILITY OF IMPACT

The chances of suffering the 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

a. 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 steppingstone 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.

b. Mapping of Risk Indicators

The Risk Register was shared with thirty-eight members of PMN that represent over ninety percent of the industry. Of these, twenty-eight members provided the completed template to PMN for sector evaluation purposes. Within these respondents, seven institutes were Microfinance Banks (MFBs), while the remaining twenty-one institutes were Non-Bank Microfinance Companies (NBMFCs) (Figure 3.1). In the previous year, the total number of reporting entities were thirty-five that provided the risk register template, out of which nine were MFBs while twenty-six were NBMFCs.

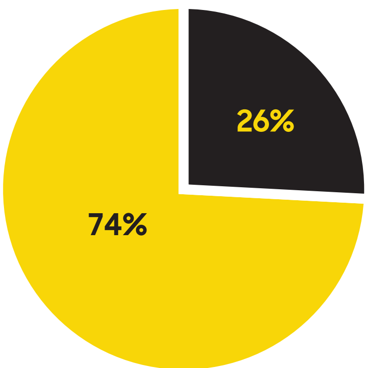


Figure 3.1:
Total Reporting Entities
■ MFBs ■ NBMFCs

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

RISK MAP		PROBABILITY		
		LOW	MEDIUM	HIGH
SEVERITY	LOW	HR Risk; Reputation Risk; Policies & Procedures; Governance; Technology; Mangement — C3	Mission Drift — C3	C2
SEVERITY	MEDIUM	Fraud Risk; Economic Conditions; Competition; Regulatory & Legal Compliance; Credit Risk; Product Risk; Liquidity Risk — C3	Financial Stability — C2	C1
SEVERITY	HIGH	C2	C1	C1

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, six risk metrics fall in the low severity and probability category, which bodes well for the sector. Seven risk metrics lie in the low Probability but medium Severity section of the matrix but remain Low in terms of criticality.

Compared with the previous Risk Map, it can be observed that all the indicators remain in the Low criticality level within the Map, except for **Financial Sustainability**, which moved to the Medium criticality. Of the Operational Risks, only the metric **HR Risk** experienced a change, as it decreased further in terms of impact. The remaining Operational Risk metrics included **Policies & Procedures** and **Technology**, which persisted in the low probability and low severity section of the matrix, whereas **Fraud Risk** remained low in terms of probability and medium in terms of impact.

Of the External Risks, risks emanating from **Competition** and **Regulatory & Legal Compliance** experienced an increase in impact. This took these risks to the medium impact and low likelihood section of the matrix. Risks associated with **Economic Conditions** and **Reputation** remained unchanged compared to the previous Risk Map.

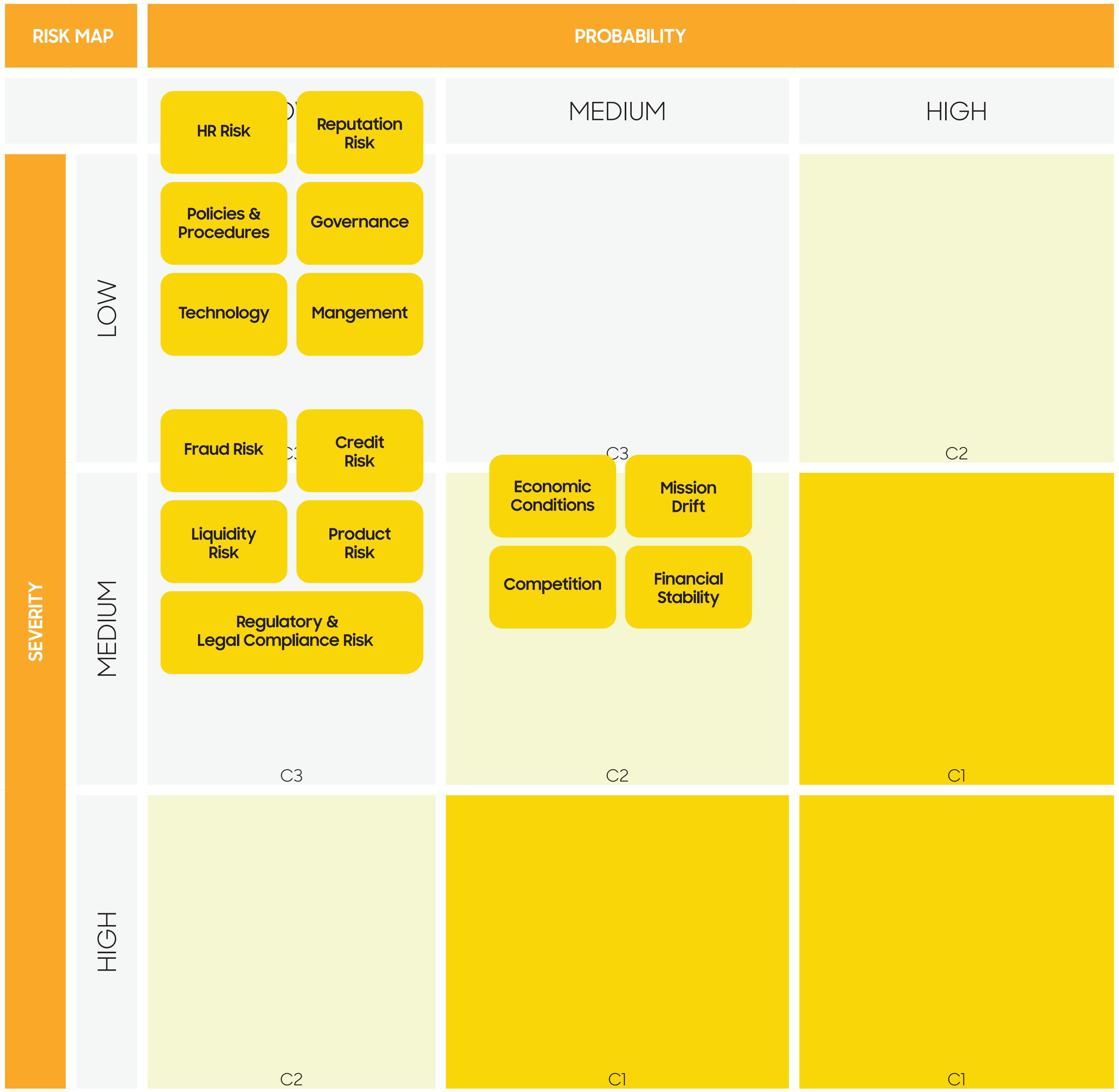
On the Financial Risk front **Liquidity Risk** increased in impact as it categorized as medium impact and low likelihood. **Financial Stability** experienced an increase in likelihood which consequently increased the risk Criticality to Medium. Lastly, **Credit Risk** remained unchanged compared to last year i.e. medium impact and low likelihood.

In terms of Strategic Risks, only **Product Risk** experienced an increase in terms of impact which characterized it in the medium impact and low likelihood category. The remainder of the associated risk metrics i.e. **Mission Drift**, **Governance** and **Management** remained unchanged.

For a more detailed analysis, the results from the consolidated risk registers were broken down into two key peer groups: Non-Bank Microfinance Companies (NBMFCs) and Microfinance Banks (MFBs). 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 considerable changes compared to the findings in the previous issue of this report. Of the Operational Risks, **Fraud Risk** rose in terms of impact which characterized it in the medium impact and low likelihood quadrant of the matrix. In comparison, NBMFCs did not consider the remainder associated metrics i.e. **HR Risk**, **Policies & Procedures** and **Technology**, as serious threats as they remained unchanged and under the low impact and low likelihood quadrant of the matrix.

Of the External Risk metrics, **Regulatory & Legal Compliance Risk** experienced an increase in impact while **Reputation Risk** decreased in impact. Risks emanating from **Competition** increased both in terms of impact and likelihood, and along with **Economic Conditions**, was classified under Medium Criticality.

Metrics of the Financial Risks of NBMFCs witnessed an increase in impact substantially. **Credit Risk** and **Liquidity Risk** were now medium in terms of impact and low in terms of likelihood. **Financial Sustainability** not only increased in terms of impact, but also likelihood, which now moved it to the Medium Criticality quadrant.

All the risks faced on the Strategic front remained unchanged except for **Product Risk**, which rose in terms of impact to medium, while likelihood remains low. However, **Mission Drift** continues to be a significant threat to the NBMFC peer group as it remains classified under the Medium Criticality.

Overall, the comparison with the previous year reveals that NBMFCs have become exposed this year as a result of the uncertainty caused by the COVID-19 pandemic. While the probability of occurrence of most risk metrics remains low, the impact of some risks has intensified because of the adverse macroeconomic conditions prevailing during the year 2020. The vulnerability of NBMFCs to **Economic Conditions**, **Mission Drift**, **Competition** and **Financial Sustainability** remain a significant challenge as appropriate measures need to be adopted to counter any adverse effects that may arise from these risks.

Figure 3.3:

Risk Map of MFB Peer Group

RISK MAP		PROBABILITY		
		LOW	MEDIUM	HIGH
SEVERITY	LOW	Policies & Procedures; Technology; Reputation Risk; Competition; Regulatory & Legal Compliance Risk; Governance; Mangement C3	Mission Drift C3	C2
	MEDIUM	HR Risk; Fraud Risk; Economic Conditions; Credit Risk; Liquidity Risk; Product Risk C3	C2	C1
	HIGH	C2	Financial Stability C1	C1

Compared to the Risk Map for MBFs of the prior year, the current year witnessed little variations. Both the Operational Risk and External Risk metrics remained unchanged.

Of the Financial Risks, Liquidity Risk grew in terms of impact while likelihood remains low. The reason for the increase in severity is primarily due to the adversity in macroeconomic conditions caused by the Global Health Crisis during the year. However, the risk remains categorized under Low Criticality.

In terms of Strategic risks, Mission Drift was perceived to increase in terms of likelihood, as it moved from low to medium. However, impact of this risk remains low. This risk is concern for MFBs as the prevailing perception of institutions is that the peer group is losing its focus on the quality of service it provides to low income people as it reaches for scale. Product Risk also experienced an increase in impact while its likelihood remains low. This could be attributable to the fact that competition continues to intensify amongst the peer group as competing products have little features to differentiate between them. Another reason for the increase in impact of this risk was due to the fact that MFBs did not have suitable that could be customized to address the needs of their client during the pandemic.

Observations of the changes in the Risk Map for MFBs depicts that while no risk indicator was considered a significant threat, Financial Stability remains the most significant risk that continues to be classified under the Medium Criticality category. With medium impact and likelihood, the risk remains a significant threat to MFBs and steps need to be taken in order to manage threats arising from this risk.

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.

The findings of the consolidated risk register were dominated by the risks that have been aggravated by the Global Health Crisis which continue to affect the industry. This also led to growth being compromised during the year as outreach flattened. Moreover, persisting concerns on the macroeconomic front, continue to put pressure on MFPs as transferring rising costs to end clients remains a debate. Additionally, the ability of clients to repay is also adversely affected which makes lending operations of service providers riskier.

Moreover, MFPs need to develop robust internal controls and risk management frameworks that should develop continuously as the industry evolves. Maintenance of relationships with clients should also be a priority which will keep MFPs updated on the financial health & funding needs of the end client's while mitigating risk.

Finally, 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.

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