Pakistan
Microfinance Network
Achieving Together

IDENTIFICATION & ASSESSMENT OF RISKS 2021

Risk Management for the Microfinance Sector

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Risk Management for the Microfinance Sector (2021)

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.

A risk register is a tool widely used by organizations for the identification and assessment of risks (Figure 1). 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 1.1: Risk Register

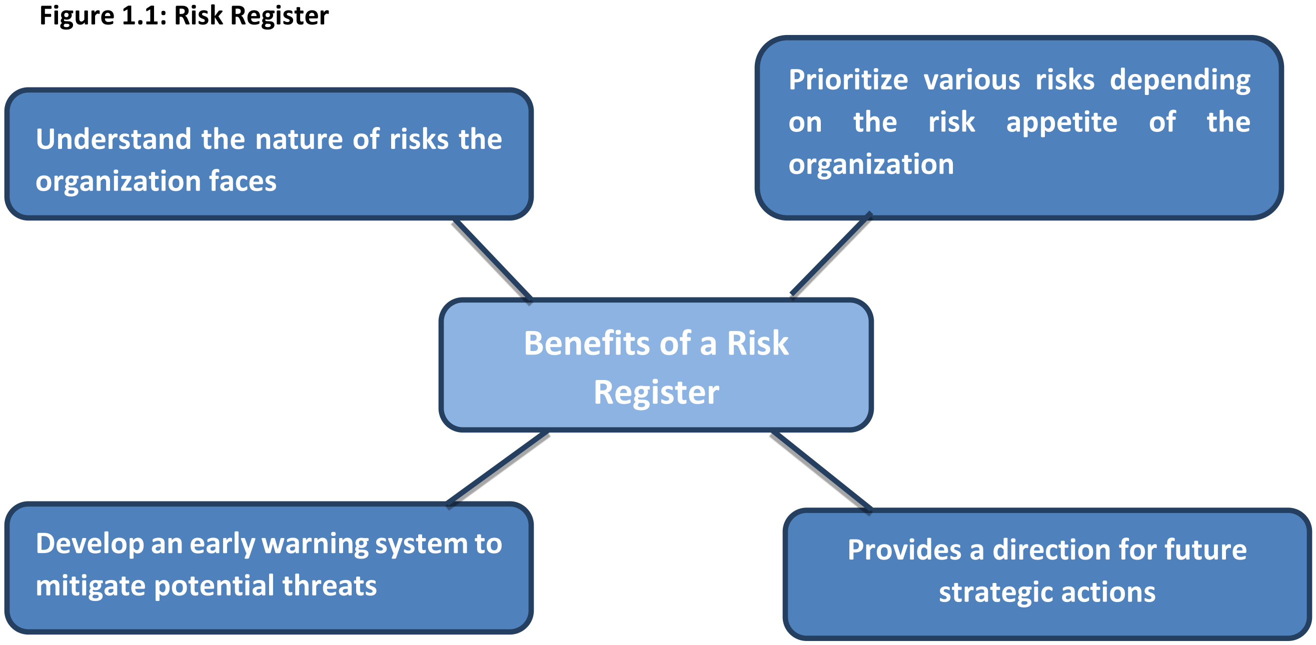


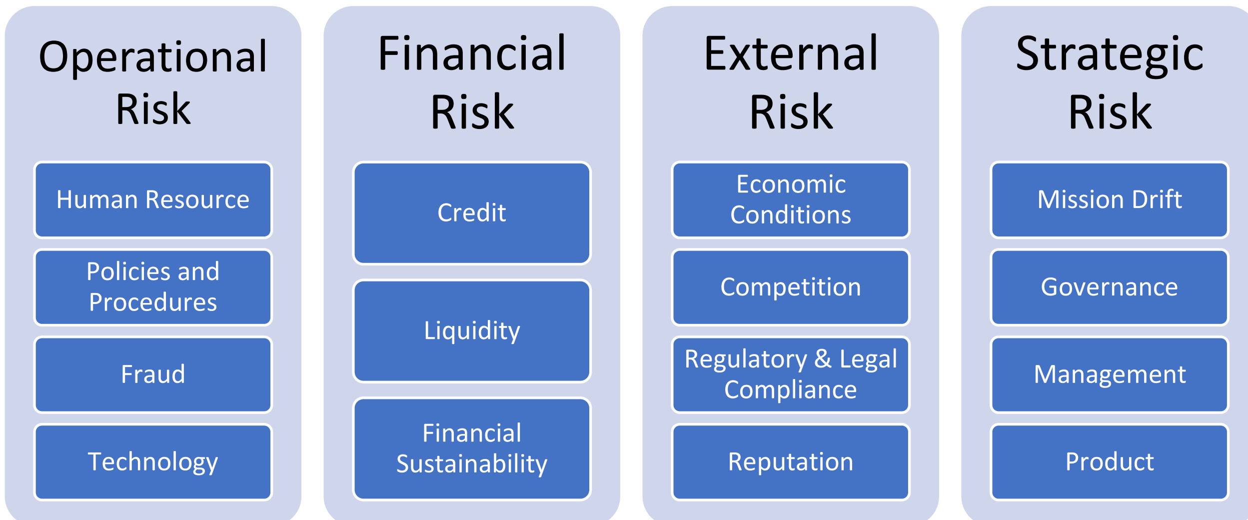
Figure 1.2: Risk Register

	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 1.2), and are calculated by a combination of quantitative and qualitative risk indicators.

Figure 2.1 shows the breakup of the sub-categories of each of the risk dimensions. 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

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.

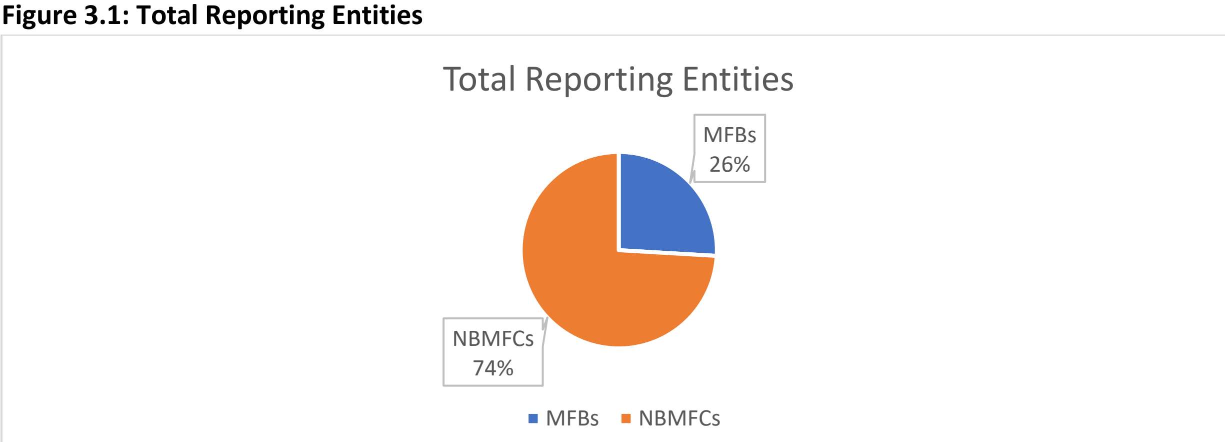
The consolidated information is utilized to formulate a Risk Map on which different risk categories are visually displayed (details to follow). The unification of risk indicators by PMN provides a holistic view of the sector's footing on risk management as weak and vulnerable areas are easily identifiable, 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

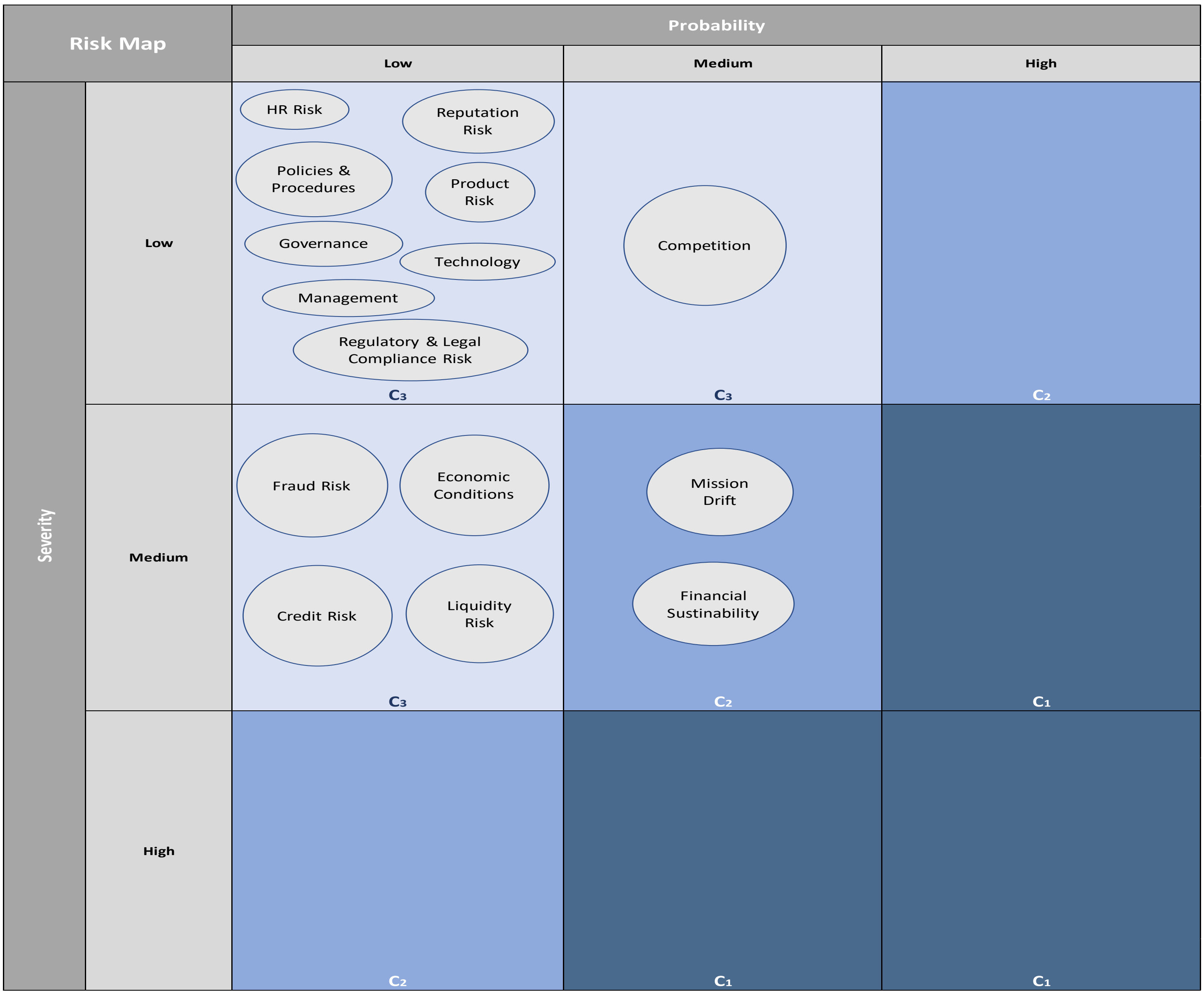
The Risk Register was shared with thirty-six members of PMN that represent over ninety percent of the industry. Of these, twenty-seven members provided the completed template to PMN for sector evaluation purposes. Within these respondents, seven institutes were Microfinance Banks (MFBs), while the remaining twenty institutes were Non-Bank Microfinance Companies (NBMFCs) (Figure 3.1). The market share represented by the reporting entities is eighty eight percent of the total microfinance outreach as of Q3 3021. In the previous year, the total number of reporting entities were thirty-five that provided the risk register template, out of which seven were MFBs while twenty-one 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 year 2021 was a challenging year due to the lingering effects of the Global Health Crisis. In the context of the Microfinance Industry, this was largely due to the fact that players facilitated their clients by deferring and rescheduling of the loans. While it was considered likely that the risks would increase for the sector once these loans come close to maturity, the sector has done well to evade Operational Risks and the suspected Financial Risks such as Credit Risk and Liquidity Risk. Mission Drift and Competition also revealed to be growing concerns.

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, eight risk metrics fall in the low severity and probability category (compared to six metrics previously), which bodes well for the sector. Four risk metrics lie in the low Probability but medium Severity section of the matrix but remain Low in terms of criticality (compared to seven previously). One risk category falls in the medium Probability but low Severity while two fall under the medium probability and medium severity cell of the map.

Compared with the previous Risk Map, it can be observed that a majority of the indicators remain in the Low criticality level within the Map, except for **Financial Sustainability**, which remained in the Medium criticality cell, and **Mission Drift**. In terms of Operational Risks, none of the metrics experienced a change, as they persisted in the low probability and low severity section of the matrix, apart from **Fraud Risk**, which remained low in terms of probability and medium in terms of impact.

Of the External Risks, threats emanating from **Competition** and **Regulatory & Legal Compliance** experienced a change. While both these risks experienced a decrease in severity, the probability of **Competition** increased. The remaining two external risks associated with **Economic Conditions** and **Reputation** remained unchanged compared to the previous Risk Map. It is noteworthy that all components of external risks were classified under the low criticality section of the matrix.

In terms of Financial Risk, all the components remained unchanged compared to the previous Risk Map for the industry. Both, **Credit Risk** and **Liquidity Risk,** held out under the medium severity and low probability quadrant, while **Financial Sustainability** continues to be a concern for the sector as it was categorized under medium in terms of both severity and impact.

Almost all Strategic Risk components were categorized under the Low Criticality level except for **Mission Drift** as this year’s analysis depicted that this was now a Medium Criticality threat given the increase in severity of the risk. The decrease in the severity of **Product Risk** resulted in the risk moving to the low severity and low probability quadrant of the Risk Map along with the risks from **Governance** and **Management**, which 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

Risk Map		Probability		
		Low	Medium	High
Severity	Low	HR Risk; Policies & Procedures; Technology Risk; Reputation Risk; Governance; Fraud Risk; Management; Regulatory & Compliance; Product Risk C3	Financial Sustainability C3	C2
	Medium	Economic Conditions; Credit Risk; Liquidity C3	Mission Drift; Competition C2	C1
	High	C2	C1	C1

The Risk Map for NBMFCs indicated some changes compared to the findings in the previous issue of this report, as four of the fifteen risks moved within the Risk Map.

Of the Operational Risks, the analysis indicated that the severity of **Fraud Risk** declined which characterized it in the low 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, the severity of the threats emanating from **Regulatory & Legal Compliance Risk** experienced a decrease. On the other hand the probability of risks arising from **Economic Conditions** declined too. This meant that the former moved to the Low Impact and Low Severity quadrant of the Map, while the latter displaced to the medium severity and low probability quadrant. **Competition** and **Reputation Risk** remained unchanged for the year, but **Competition** continues to be a considerable concern for the industry as it was categorized as a Medium Criticality risk.

In terms of the Financial Risks of the NBMFCs, **Credit Risk** and **Liquidity Risk** remained the same as last year i.e. categorized as medium in terms of impact but low in terms of probability. However, **Financial Sustainability** experienced a decrease in the level of severity which now displaced the risk to the low severity and medium probability quadrant of the map. All these risks lingered under the low criticality level.

All the risks faced on the Strategic front remained unchanged compared to the prior year. While most of these categories categorized on the low probability and low severity quadrant, **Mission Drift** persisted as a medium criticality threat for the NBMFCs.

Overall, the comparison with the previous year reveals that NBMFCs have managed to contain most risks exposed last year as a result of the uncertainty caused by the COVID-19 pandemic. The peer group did well to manage the probability of occurrence and impact of most risk metrics. The vulnerability of NBMFCs to risks associated with **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 in the future.

Figure 3.4: Risk Map of MFB Peer Group

Risk Map		Probability		
		Low	Medium	High
Severity	Low	Policies & Procedures; Technology; Product Risk; Regulatory & Legal; Governance; Management C3	Mission Drift; Competition; Credit Risk C3	C2
	Medium	HR Risk; Fraud Risk; Liquidity Risk; Financial Sustainability; Economic Conditions; Reputation Risk C3	C2	C1
	High	C2	C1	C1

Compared to the Risk Map for MFBs of the prior year, it was revealed that only four risk categories were displaced to different quadrants. Surprisingly, though, none of the categories were classified under the medium or high criticality levels, compared to just one (Financial Sustainability) last year.

In terms of **Operational Risks**, all categories remained unchanged and persisted to be in the low severity and impact quadrant. On the **Financial Risks** front, all three categories were classified under the low probability and medium in terms of severity, including **Financial Sustainability**, which was a medium criticality risk previously.

On the **External Risks** front, there was prevailing concern regarding **Competition**, which grew in terms of probability. Additionally, **Reputation Risk** also grew in terms of severity, as it now settled in the low probability and medium severity quadrant.

Of the Strategic Risks, all categories remained unchanged compared to the previous year, except for **Product Risk**. With the reduction in the severity level, Product Risk now displaced to the low severity and low probability quadrant along with all other risk categories. **Mission Drift** was the only risk category under Strategic Risks that stood at low severity and medium probability quadrant of the map.

The changes in the Risk Map of the MFBs indicated that this peer group have been successful in managing their risks, primarily those which were previously classified as medium criticality. Constructive steps need to be taken by this peer group to manage the severity of risks classified under the medium level, particularly: **Liquidity Risk, Financial Sustainability** and **Economic Conditions**, in order to prevent their movement to a higher criticality level.

4. Future Actions

The key function of this exercise is to provide management, the board, and key stakeholders with significant information on the main risks faced by the industry. The risk register also gives the institution's risk management stakeholders a clear view of the current status of each risk, at any point in time.

The previous findings of the consolidated risk register were dominated by the risks that had been aggravated by the Global Health Crisis and continued to affect the industry. However, the findings of this year's Risk Map indicated that the industry has been recovering gradually, as growth in outreach has also once again picked up.

It is recommended that the Risk Map for the industry and respective peer groups should be used as a benchmark by institutions to develop an appropriate and robust Risk Management Framework. This framework would prove essential in monitoring and consequently managing the key risks being faced by the institution.

In order to mitigate external risks (specifically Climate Risks), PMN is actively advocating the development of a meso level Disaster Risk Fund at different national and international forums. The sector-level Fund will ensure that adequate financial resources are available to protect the sector and its clients before a natural disaster strikes. These resources would then be available quickly to the MFPs to continue lending in the communities which are or may become vulnerable to climate risks. PMN is currently in the process of consolidating resources to conduct a thorough risk assessment nationally with respect to each MFP's potential risks, prevention, and reduction strategies, matching their location vulnerability with the disaster risk mapping. This will help in identification of disaster risk zones affecting the MFPs and its clients, along with impact-measurement, which will help in deciding the insurance/ risk transfer needs of each individual institution.

Lastly, based on the findings of the risk register, the persisting challenges on the external and strategic front 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 the capacity of PMN members that will eventually aim to mitigate these risks.

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