Identification & Assessment of Risks 2022

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Risk Management for the Microfinance Sector (2021)

1. Risk Register Tool – An Introduction

Microfinance providers (MFPs) must properly manage risks in order to accomplish their financial and social goals since risk is a fundamental component of the financial services industry. Microfinance companies must have a comprehensive risk management framework in place in order to proactively set up procedures that support company goals while reducing risks to a manageable level.

The Pakistan Microfinance Network (PMN) has taken proactive measures to encourage responsible risk management among microfinance practitioners in Pakistan. The first Risk Register for the Pakistani microfinance sector was introduced by PMN in 2016 as part of its long-term goal to ensure sustainable growth in the industry.

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.

Although most MFPs have prioritized risk management for quiet some time, few MFPs have just recently established a risk management function. Such a tool, according to PMN, will help MFPs (particularly those without current risk management frameworks in place) comprehend the types of risks that businesses face at the strategic and operational levels. Significant information on various dangers will be made available to management and key stakeholders via the risk register, which can be used to create risk management plans to reduce possible hazards.

Figure 1.1: Risk Register

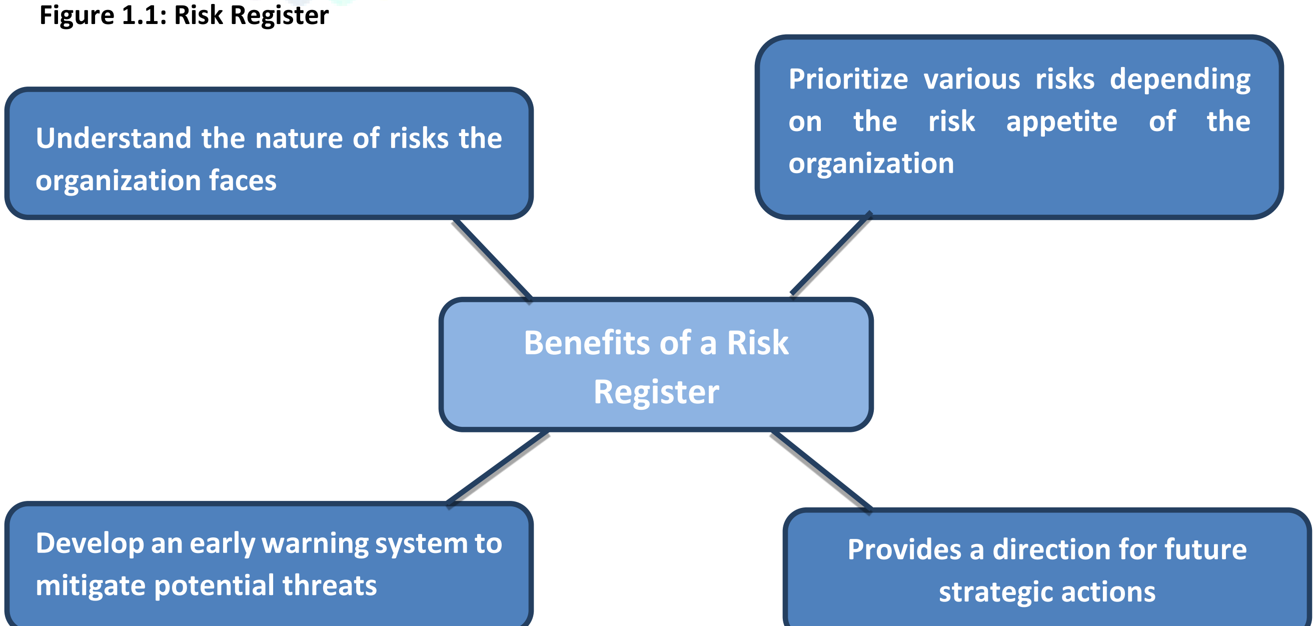


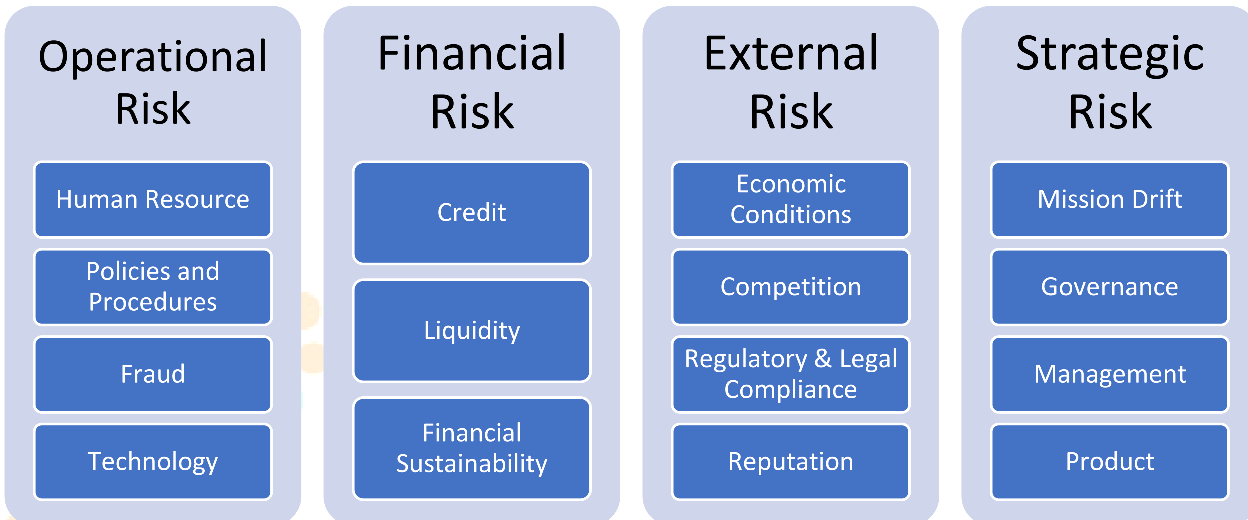
Figure 1.2: Risk Register

	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 severity and probability of an impact indicate the possible threat to an institute from each sub-subcategory of risk. The risk indicators used to construct both measures, which are an essential part of the Risk Register (shown in Figure 1.2), are a combination of quantitative and qualitative risk indicators.

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 2.1 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

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?	Yes		0
2	How frequently does the Asset Liability Committee (ALCO) review the liquidity position of the organization?	Monthly		0
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?	Monitor and sets limits		0
8	Percentage of branches in which cash float is determined daily?	Greater than 80%		0
9	The trend in PAR > 30 days over the last 12 months?	Increased		2
				33%

	SEVERITY	Answer	Explanation	Risk Meter
1	What percentage of total funding is expected to mature within the next 12 months?	Less than 30%		0
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		2
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
				25%

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.

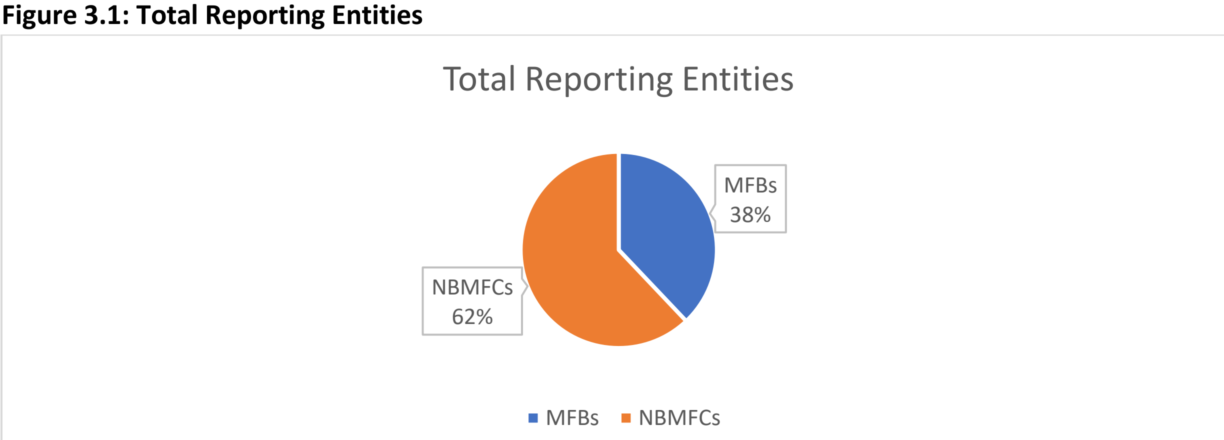
The aggregated data is used to create a Risk Map that visually displays the various risk categories (details to follow). Since developing and potential threats are readily discernible, along with weak and susceptible regions, the unification of risk indicators by PMN offers a comprehensive perspective of the sector's standing with regard to risk management. When developing sector-wide risk mitigation plans for long-term sustainability and growth, this information will be useful.

For MFPs operating without a formal risk management framework, the Risk Register is the most helpful in terms of institutional strengthening. By assisting the organizations in the identification and assessment of possible dangers, the tool acts as a first step in the development of effective risk management systems for these businesses (mainly non-bank MFPs). It should be emphasized that a select group of top-tier microfinance companies have created their own risk registers that are specific to the quirks and complexity of their organizations.

b. Mapping of Risk Indicators

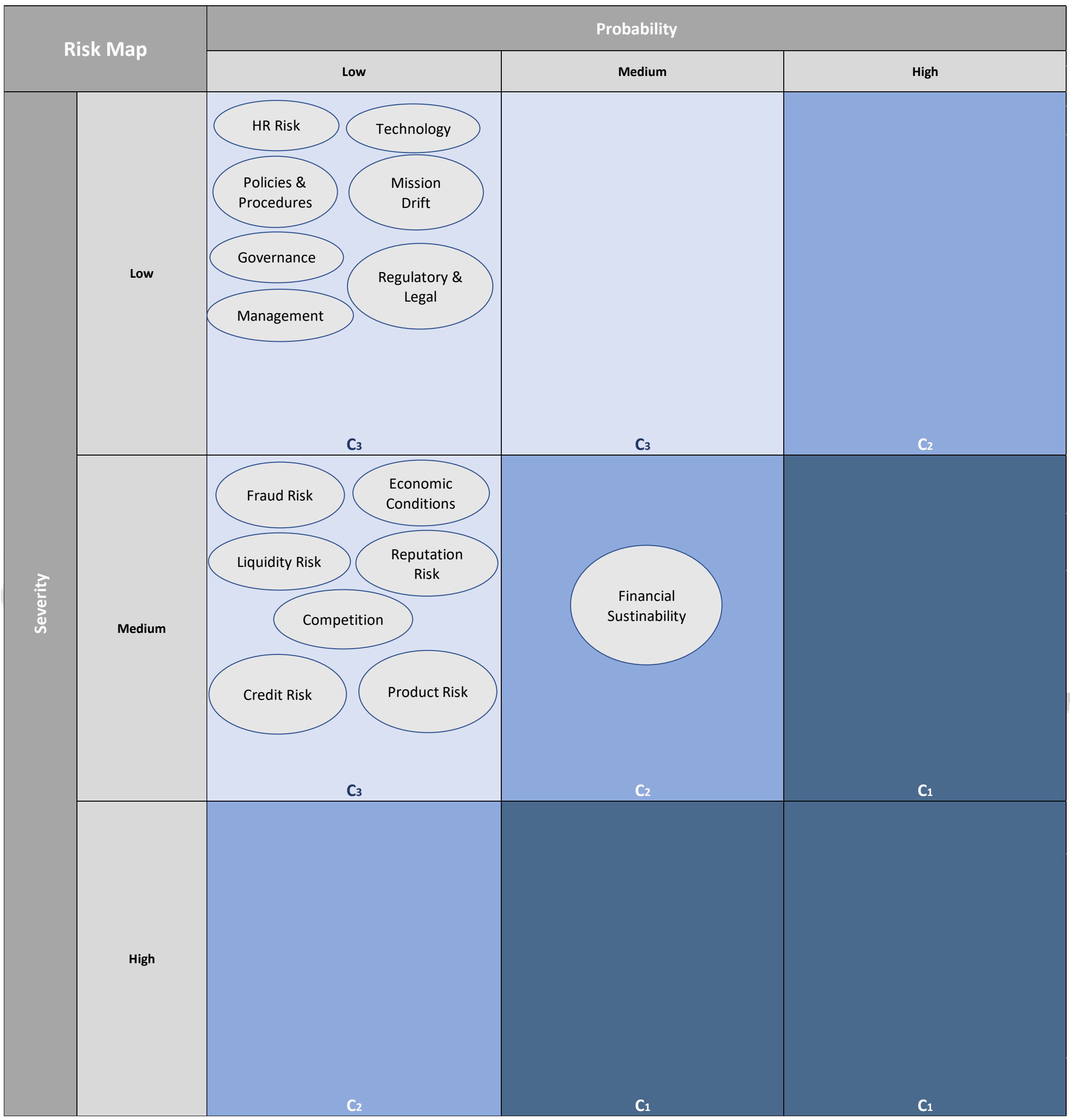
The Risk Register was shared with thirty-six members of PMN that represent over ninety percent of the industry. Of these, twenty-nine members provided the completed template to PMN for sector evaluation purposes. Within these respondents, eleven institutes were Microfinance Banks (MFBs), while the remaining eighteen 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.

Fiscal year 2022 was another challenging year for Pakistan, while the impact of Covid-19 was gradually phasing out and V shaped recovery was accelerated. However, new uncertainties emerged which includes deteriorating economic conditions and natural calamities, hence making fiscal 2022, a challenging year for Pakistan. In the context of Microfinance sector, similar situation was prevailing as the deferment and rescheduling of loans were not granted access which translated increase in costs for MFPs. With the macroeconomic variables and economic conditions posed challenges for the microfinance sector, the sector risks profile also changed in lieu of volatile economic conditions. On the flip side, majority risk indicators are on low probability axis which depicts a moderate healthy side.

The key findings from the sector risk map are that majority risk indicators are essentially distributed in the low category (in terms of probability level), of which, seven risk metrics fall in the low severity and probability category (compared to eight metrics previously), which bodes well for the sector. Seven risk metrics lie in the low Probability but medium Severity section of the matrix. Only Financial Sustainability is an exception with medium Probability and medium Severity.

Breaking the matrix in components, in Operational Risks, none of the metrics experienced a change, as they persisted in the low probability and low severity section of the matrix. However, **Fraud Risk** continues to be low in terms of probability and medium in terms of impact.

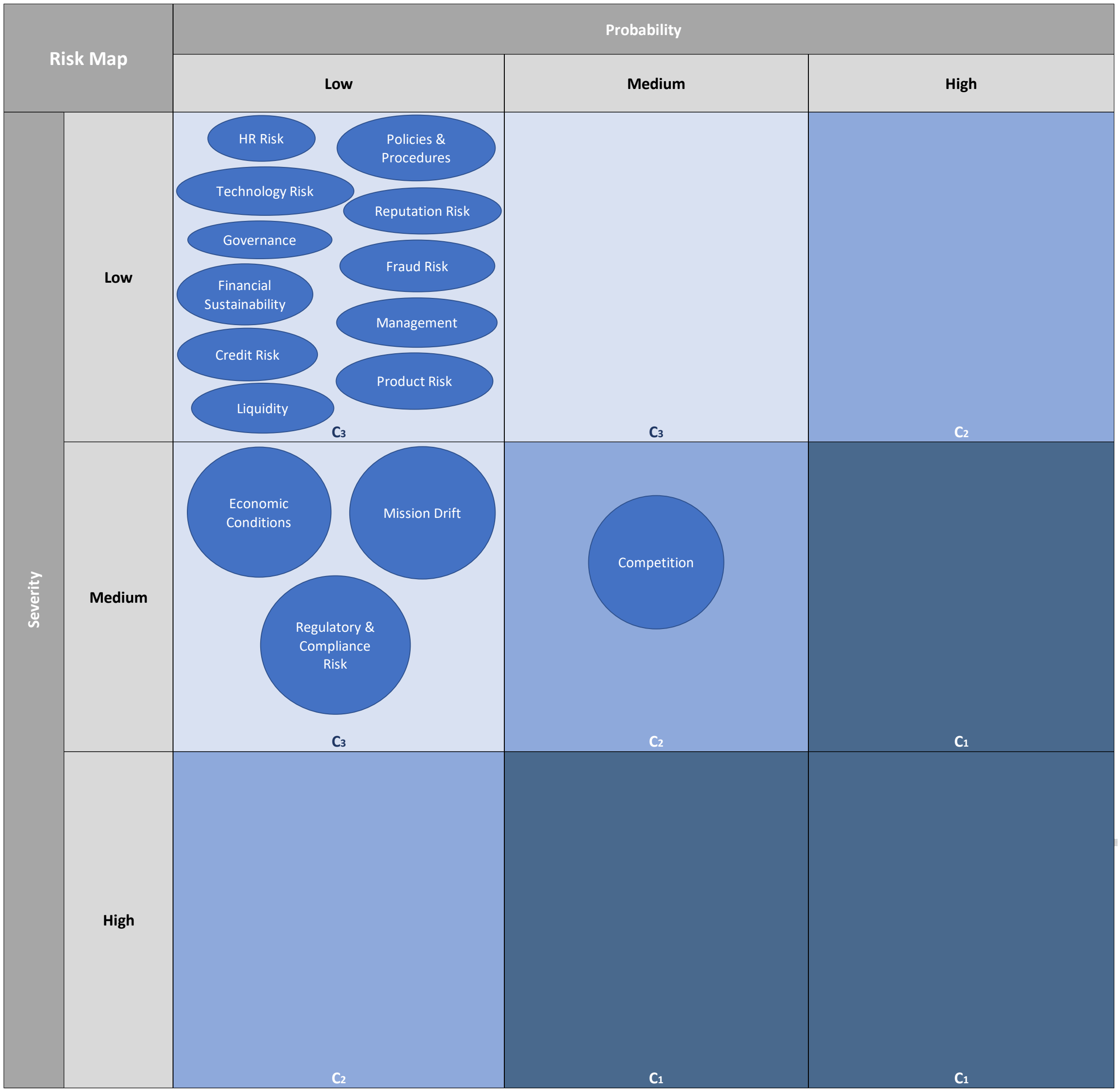
From analyzing the External Risks, it is observed the most shifts in the risk landscape is primarily due risks under the umbrella of external risks. **Competition** and **Reputation Risks** experienced a change from low severity to medium severity, however, compared to the previous fiscal year, the probability is the still i.e., low. It is noteworthy that despite increasing spikes in interest rate and a natural calamity affecting the whole country, **Economic Condition,** unlikely, continues to be on low probability and medium severity axis. **Regulatory and Legal Compliance** is the only risk which remained unchanged.

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.

Looking at the Strategic Risk components, **Governance, Management** and **Mission drift** were categorized under the Low Criticality level while **Product Risk** shifted from low criticality to Medium Criticality, given the increase in severity of the risk. The decrease in the severity of **Mission Drift** resulted in the risk moving to the low severity and medium 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



Analyzing the Risk Matrix of NBMFCs indicates some changes as compared to prior fiscal year, 2021. as three risks indicators shifted their position within the Risk Matrix.

Of the Operational Risks, the analysis indicated that the all the risk components remained unphased and all four components – **Fraud Risk, HR Risk, Policies & Procedures and Technology** were on the low probability and low severity quadrant.

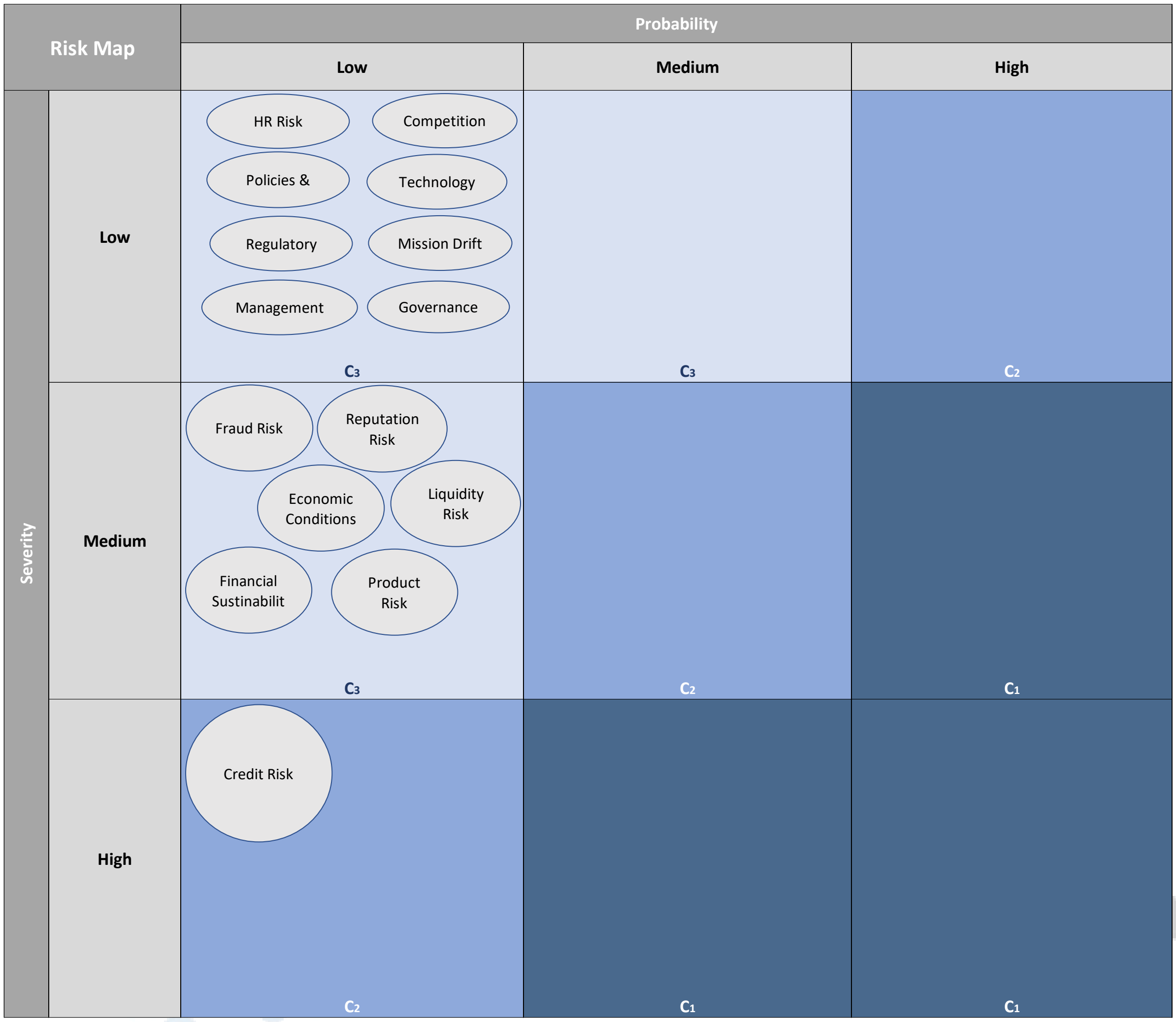
Of the External Risk metrics, surprisingly all four components of the external risks remained unphased. While Competition and Economic Condition are on the Medium Severity Axis, Regulatory & Legal and Reputation Risks are on Low Severity axis, three of them are on low likelihood axis while **Competition** remains an exception which resides on medium likelihood.

Moving to the Financial Risk landscape, the components of Financial Risk displayed variation in NBMFCs, **Credit 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 an increase in likelihood which now placed the risk to the low severity and low probability quadrant of the map whereas **Liquidity Risk** improved its position from medium severity and Low Likelihood to low severity and low likelihood quadrant.

On the Strategic Risks Front, components displayed movements risk matrix. **Mission Drift** shifted from medium impact and medium likelihood to medium impact and low likelihood, which primarily due to the restrictions of Covid-19 lifted and operations being resumed. On the flip, **Product Risk** severity increased from low to medium while the likelihood remained unphased i.e., low. **Governance and Management** remained at the low likelihood and low severity quadrant.

Overall, keeping in context the events in fiscal year 2022, unlikely results were observed on NBMFCs landscape, especially where macroeconomic variables were experiencing volatile movements and the natural calamity affecting all majority areas of the country. The limitations of NBMFCs to raise capital and prevent themselves from liquidity crunch in this event was a serious ambiguity and it was expected liquidity and economic associated components will pose a greater risk to these NBMFCs. Hence, NBMFCs have displayed a mature effort in curtailing and minimizing risks especially at **Economic Risks** and **Financial Risks** Front. However, **Mission Drift, Competition and Product Risks** needs to be analyzed with microscopic approach as when these risks are not unaddressed in the long term, these risks lead to long term affects on the institutes as well on the sector.

Figure 3.4: Risk Map of MFB Peer Group



Compared to the Risk Map for MFBs of the prior year, it was revealed that only five risk components were displaced to different quadrants. While HR risks displayed a positive trend on severity levels and **Mission Drift and Competition Risk**, the alarming situation is **Credit Risk** severity level, which has shifted from medium severity and low probability to high severity and low probability.

In terms of **Operational Risks**, all categories remained unchanged and persisted to be in the low severity and impact quadrant with the exception of HR risks which shifted from medium severity level to low severity level.

On the **External Risks** front, similar position was taken by components where **Economic Conditions, Regulatory & Legal Compliance and Reputation Risk** remained unchanged compared to previous fiscal year while **Competition Risk** there was prevailing concern regarding **Competition** displayed a positive trend on likelihood axis as it decreased from medium to low.

On the **Financial Risks** front, **Liquidity and Financial Sustainability risk** categories were classified under the low probability and medium in terms of severity, while **Credit Risk** presents an alarming situation where it went from medium to high severity levels.

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Of the Strategic Risks, **Governance and Management** remained unchanged compared to the previous year, while **Product Risk and Mission drift** were the exceptions. With the increase in the severity level, Product Risk now jumped to the medium severity and low probability quadrant while **Mission Drift** was stood changed its position to low severity and low probability quadrant of the map.

Overall the performance of MFBs is in dilemma, where risks like Operational Risks are minimized to the lowest level**,** critical evaluation is required on the end of Financial Risks especially **Liquidity Risks and Credit Risks.** The severity levels of **Credit Risks** being high stems from high PAR values. Risk like Credit risks need to be viewed under the microscopic lens to analyze and mitigated or reduced in short term or if not possible then, medium term else the risks is volatile and can react with other risks like liquidity to presented a bigger challenge, not at institutional levels but at macro levels as well

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.

It is advised that institutions utilise the risk maps for their specific peer groups and industries as a benchmark for creating a suitable and effective risk management framework. The institution's major risks would need to be monitored and afterwards managed thanks to this structure.

PMN actively promotes the creation of a meso level Disaster Risk Fund at various national and international venues in order to reduce external risks, particularly climate threats. The sector-level Fund will make sure that enough money is available before a natural disaster strikes to protect the sector and its customers. The MFPs would then have access to these resources to continue making loans in the communities that are or could become exposed to climate concerns. Currently, PMN is gathering resources to carry out a full risk assessment around the country with regard to each MFP's possible dangers, prevention, and reduction measures, aligning their location vulnerability with the disaster risk mapping. The identification of disaster risk areas that affect MFPs and their clients, as well as the impact assessment, will aid in determining the insurance/risk transfer requirements of each specific institution.

Moreover, in order to identify viable risk mitigation strategies, the industry's ongoing external and strategic problems will be discussed at the PMN's Risk Forum based on the results of the risk register. Additionally, under the auspices of PMN's Center of Excellence (CoE), trainings and capacity-building activities for MFPs are to be planned in order to increase the ability of PMN members to eventually strive to reduce these risks.