Risk Management

Overview

MicroSave has been working in the area of risk management for over a decade. *MicroSave*'s original risk analysis framework was developed in collaboration with ShoreBank and focused on product and institutional risks. The risk environment has since become more complex than ever, with changes in the sector. To respond to this complex risk landscape *MicroSave* developed a new toolkit on risk management, with support from Standard Chartered Bank.

Risk is inherent to any business and financial institution, especially the ones that focus on the bottom-of-the-pyramid segment. What makes the financing of low income people special is the absence or near absence of traditional risk mitigation mechanisms like collaterals and guarantees. Management of credit risk, therefore, becomes extremely important for all financial institutions (FIs) focused on the low income market segment. All FIs, and particularly the microfinance institutions MFIs that have transformed from a social development background, face a growing range of complex operational risks. Failure of a particular process, staff and client frauds, MIS failure are some of the risks that are not uncommon to have a direct bearing on the day to day functioning of the institution.

In the recent times, the FIs (particularly nascent ones in this space) have been shifting away from the traditional grant funds and are increasingly relying on the commercial bank funding. Increasing integration of the microfinance sector with the mainstream financial sector, product development, diversification into new geographies and cross border funding not only adds complexity to the credit and operational risks but also poses additional risk in the microfinancing risk landscape. Additional risks that need proactive management are interest rate, liquidity and foreign exchange – these may be collectively put under the broader category of financial risk.

The three major risks credit risk, operational risk and market risk (which includes financial risks - interest rate and currency risk) also make one important pillar under Basel II norms for the banking sector.

In addition, there is always a risk of failure of the strategic choices made by the FIs. Mission drift and governance are the issues that have come to fore amongst MFIs in particular. Therefore FIs will need additional emphasis on strategic risks**.** A proactive and systematic management of all the above risks will be very important for the growth and sustainability of any FI.

The framework discusses the concepts of risk and risk management to develop conceptual clarity on these subjects. The framework in the diagram to the right is used for managing risk in FIs. Each step is discussed in detail. It also discusses the techniques to identify and assess risks. It then goes to develop strategies that the FIs can use to deal with the risk. Specific tools and techniques to manage risks to acceptable levels are discussed next.

Various frameworks and approaches to manage each of these risks are dealt with. Towards the end, is a comprehensive risk reporting framework that FIs can find extremely useful to manage and report risks, and to improve and update their risk management systems.

Benefits

Overall, use of this framework will enable the FIs to formalise risk management mechanism in house which is likely to help evolve a risk culture within the institution. Some specific benefits that *MicroSave*'s clients have derived from the framework are:

- *Improved Understanding of Business and Risks:* All clients using the Risk Management toolkit to develop risk analysis framework report a clearer and more comprehensive understanding of their business and a wide range of risks they face – many were solely focused on credit risk prior to the exercise. Grameen Financial Services Private Limited (GFS) and P-KGFS in India, used the Risk Management toolkit to identify the key risks (such as credit, fraud, liquidity, governance, HR risks) emerging from the internal and external environment, and accordingly develop risk management matrix to prevent, monitor and control them. The toolkit helped both clients define the risk mitigation tactics, indicators and institutional threshold for measuring and monitoring of identified risks. In additional, a risk management feedback loop was developed to identify key staff's role in the execution of the new risk management system.
- *Strengthened Governance:* Almost all clients report strengthened governance, since the Board is able to review the risk analysis matrices. At Equity Bank in Kenya, the management Asset-Liability Committee (ALCO) meets weekly to assign and review individual responsibilities along with their functional duties. The ALCO submits monthly, reports to the Board of ALCO and Risk Management Committee and produces a quarterly report for deliberation by the full Board. In India, GFS has developed monitoring and reporting framework for risk management wherein the Management Committee analyses the indicators and thresholds for various risks during its monthly meeting. P-KGFS has set up a risk management committee that meets monthly and has a mandate to monitor the identified risks and overseeing the risk mitigation efforts wherever required.
- *Satisfying Supervisory Authorities*: FINCA-Uganda, Uganda Microfinance Limited and U-Trust all found that the implementation of risk analysis and process mapping helped them respond to the issues and concerns raised by the Bank of Uganda's supervisory department. Similarly, Tanzania Postal Bank used the risk frameworks it has developed to respond to Bank of Tanzania's supervisory reports. Equity Building Society's transformation into a Bank was greatly facilitated by the comprehensive risk analysis and management systems it implemented.
- *Proactive Management*: All clients implementing the toolkit found that clearly assigning responsibility for different risks meant that the risks facing the organisation were much more proactively monitored and managed – thus reducing the need for *post hoc* "fire-fighting" trying to manage risks after the risk event has occurred. Both GFS and P-KGFS have identified risk owners for all the key risks that were identified during the risk analysis. This has helped them to establish clear cut accountability for management of each key risk.
- *Risk Appetite*: Equity Bank's Board sets the risk thresholds for all aspects of bank's operations and exposures. The Board ensures that it meets or surpasses applicable and explicit statutory prudential requirements set by the Government, Central Bank and the Ministry of Finance.
- *Enhanced Compliance with Procedures*: Equity Bank realised after introducing new procedures through process mapping that it needed to ensure compliance. It developed a compliance checklist to check regularly on the extent of compliance. Other clients from different countries (such as India and the Philippines) are now using compliance systems to improve the consistency of process and quality of services throughout their branch networks.
- *New Risk Management Functions*: Several of the larger clients, including Equity Bank, Kenya Post Office Savings Bank and Tanzania Postal Bank have established a new Risk and Compliance Department. GFS in India, after the implementation of the framework, has set up a risk management function to monitor the risk environment on a regular basis and take proactive steps to manage those risks crossing the threshold limits.
- *Risk management training and preparation of Risk management policies*: 'Wisdom Microfinancing Institution (S.C)', Wisdom is a microfinance institution working in Ethiopia. As a part of the technical assistance MicroSave helped Wisdom design its risk management systems. More specifically, we developed their risk management manual, monitoring tools and risk management. As a result Wisdom was able to submit the Risk Management Manual to the Central Bank of Ethiopia and comply with the legal requirement.

Proactive risk analysis and management is the basis for robust and successful financial institutions!