# *MicroSave* Briefing Note # 122

## Risk Management for MFIs - II

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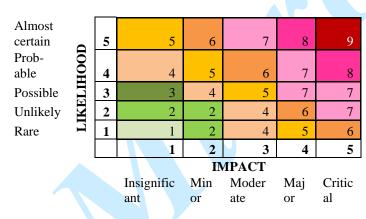
#### Introduction

In the first Note (Briefing Note # 121) in this series, we covered some of the basic aspects of risk management including understanding risk terms, risk identification, risk prioritisation etc. In this Note we extend these concepts further to help setup risk management systems in an MFI.

In this Note we will discuss how to calculate risk scores; how to develop and use risk monitoring tools; how to set responsibilities; how to develop the risk management structure within the organisation; and how to develop risk reporting structures and a business continuity plan.

#### Risk Assessment

The previous Note in this series discussed prioritisation of risk scores on the basis of frequency and impact of the risk. Risk assessment is performed on similar lines using the frequency and impact of the risk. Based on the combination of these two 'inherent risk' scores are calculated. Frequency and impact are mapped in the form of a matrix where a combination of these two factors generates a score for the inherent risk. Following matrix can be used to calculate inherent risk scores:



Once the inherent risk scores are decided, it becomes easier for management to track them and take risk mitigation steps. GO Finance in India uses this method to calculate inherent risk scores to assess different types of risk.

An important question now is, "How do we decide the likelihood and impact of selected risk over time, or even at the time of risk assessment?" The answer to this question

lies in the sources that the organisation uses to assess risk. In many organisations internal audit reports are used to decide on the inherent risk score. However, audit reports rarely provide insights into all types of risk that an organisation faces as the scope of audit is often be limited to operations. In such cases, various types of management reports: budgetary analysis; financial performance reports; operations reports; human resource reports; competition analyses etc. can be used to decide on the inherent risk scores. Based on these sources of information, indicators for specific risk areas can also be identified, and used to assess risk scores over time.

Management can also decide on the threshold levels for these risk indicators. This will not only facilitate tracking performance, but also in comparing its results against industry benchmarks. However, it is important to note that industry benchmarks may not be available for all risks identified by the MFI, as more often than not many risks will be unique to each organisation.

### **Monitoring Tools for Risk Management**

Once the risk scores have been decided, the next step is to develop risk monitoring tools so that performance assessment can be done on a continuous basis. Different organisations have developed and used different types of risk assessment tools suited to their operations. A closer analysis of these tools reveals following essential features:

- 1. The starting point for developing any risk monitoring tool is the inherent risk scores calculated using the matrix for each particular risk area.
- 2. On the basis of the inherent risk scores, weights for the selected risk area are decided.
- 3. These weights are then used to calculate individual risk scores, which (when added up) generate an overall risk score for the organisation, a particular functional area, or branch.
- 4. For comparison, threshold levels for each risk area are also decided and the calculated risk scores are assessed against them. Some organisations also perform a trend analysis to assess the performance over a time period.

Following the method above, risk monitoring tools for different levels within the organisation can also be

<sup>&</sup>lt;sup>1</sup> See MicroSave's Risk Management Toolkit

developed for example for the entire finance department, for a branch of an MFI etc.

Risk monitoring tools are important and form one of most essential parts of a risk management system. Grameen Koota, an MFI operating out of Bangalore in India, has developed a comprehensive risk monitoring tool for risk management. Utkarsh another Indian MFI has developed risk monitoring tools for its branch level operations.

#### **Frequency of Risk Assessments**

How often should the risk assessment be done? The answer varies from organisation to organisation, because of their differing needs and stage of organisational development. Organisations like GO Finance in India perform quarterly risk assessment of their branches and monthly risk performance assessment of other functional areas. The frequency of risk assessment also depends on the organisation's resources, as well as its needs, as risk assessment is a resource-intensive exercise.

#### **Risk Management Strategies and Practices**

There are four basic strategies to risk management – Avoid, Transfer, Accept and Control (in short ATAC). These strategies are based on the nature of risk, and on the risk appetite of, and decisions made by, the organisation. The follow up actions to mitigate risk then depend on the strategies adopted by the organisation. Multiple strategies can also be used simultaneously. For example, managing credit risk by creating a loan impairment allowance is an example of acceptance; while following group methodology, and securitisation or a loan sale are examples of risk transfer.

Even after putting control measures in place, some level of risk always exists. This portion of the risk is called 'residual risk' or the remaining portion of the risk. Scores for residual risk can also be calculated using the matrix for risk scoring. The concept of residual risk is important. Over time, while comparing risk scores from a series of risk assessments, the aim of the management should be to reduce residual risk.

Once the risk strategies have been identified, it is the responsibility of individual departments and branches to implement those strategies and reduce the residual risk in the system. Everyone within the organisation is responsible for containing risk. Specific responsibilities and tasks should be assigned to each employee to reduce risk scores. Once specific responsibilities for a particular risk or risk area have been set for a person, s/he becomes the 'risk owner' for that risk. For the purpose of risk management different functional heads or branch heads

are made risk owners for risks related to their part of the organisation.

#### **Risk Management Structure and Reporting**

A separate risk management unit can be established to work with the risk owners within the organisation. The risk management unit of Wisdom Micro Financing in Ethiopia co-ordinates and works with different departmental heads to conduct risk assessment and monitor risk scores.

Risk reports are mainly a management tool to assess and manage risks and take corrective actions. Therefore, risk reporting in most organisations is to the senior management committee or to the head of the organisation.

Larger organisations often have a risk management committee of the board to which risk reporting is done. In case there is no risk management committee, risk reports can also be presented to the board. At GO Finance, risk management reports are one of the main documents for discussion during board meetings.

#### **Business Continuity Planning**

There are some high impact risk events that may occur even after the use of risk management strategies. For example risk arising out of catastrophic events, sabotage, accidents, collusion and fraud etc. These occurrences are often debilitating and may bring the operations of the organisation to halt.

Business continuity planning is for such a situation, so that the organisation can re-start its operations and return to normalcy as quickly as possible. The scope of continuity planning is to cover: the identification of exposure to threats in different scenarios; and possible prevention and recovery strategies, including action points to allow the organisation to continue operations in adverse conditions.

#### Conclusion

Risk management in an organisation has very wide scope, as it necessarily covers all its functions. It is also an unending process under which continuous efforts are required from everyone in the organisation. However, setting up risk a management function is not very difficult. Any organisation with the need to reduce risks in its operations and functioning can work to develop its own risk management systems, so that they are best suited to its level and complexity of operations.