

MicroSave Briefing Note # 34

Implementing Risk Management at *MicroSave*'s Partner Microfinance Institutions

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Introduction

Risk management is at the core of the Basel II guidelines and essential to optimising the performance of microfinance institutions (MFIs). Recognising the need for proactive risk management, *MicroSave* and ShoreBank Advisory Services studied the current state of risk management in four of *MicroSave*'s Action Research Partner (ARP) organisations². Based on that study, a toolkit to assist MFIs to establish a risk management function, with emphasis on managing risk during new product development, was developed and field-tested at 3 ARPs.

All three ARPs did not have a formal, centralised risk management function. The first step was to get buy-in from the Managing Director of each institution to begin to construct a risk management system. The Managing Director selected a team and a leader to drive the process.

Built on the risk management feedback loop³, each ARP began by identifying all risks within their organisation, assessing frequency and impact, and prioritising risks. The priority risks were analysed to determine risk drivers. Risks were then assigned "risk owners" – senior staff responsible for monitoring the frequency of the risk through appropriate indicators and thresholds for risk tolerances. Finally tactics to mitigate these institutional level risks were developed.

Thereafter, product operational risks and risk drivers were specifically identified. These risks were assessed for frequency and impact, and mitigating tactics were developed. As new products are ready to be launched, the ARPs assessed the adequacy of the pilot test phase's risk management systems, and developed additional stress indicators for rollout. ARPs discovered that the product operational risk tools can be used retrospectively to assess risk management as well as during product development, and plan to apply these tools to their existing products.

Introducing a formalised risk management approach within an organisation represents a significant culture change. ARP managers knew their problems and risks, but had not thought of their problems from a risk perspective, nor did they perceive themselves to be "risk owners". When asked to identify risks, managers frequently responded "We don't have that problem" – probably because the risk was believed to be well-managed.

However, this does not remove the risk. Once managers have ownership, they need the tools to help manage their

risks, to put the theory into practice. Participating ARPs felt *MicroSave*'s "[Toolkit for Institutional and Product Development Risk Analysis](#)" allowed them to do so. One CEO commented that senior managers are now thinking in terms of risks, showing the beginning of a risk culture change and ownership.

Identifying Risks

Risk analysis involves the identification of the risk components by answering the following questions:

- What is the risk event?
- What drives it? and
- How it can be monitored?

MFIs need to identify risk drivers, since it is the drivers that must be addressed. One symptom (high default rate), can represent one of several risk events (concentration of loan portfolio in one sector, clients do not or will not pay etc.), each of which may have a different set of risk drivers (drop in commodity price/increased cost of raw materials, inadequate monitoring procedures poor client selection etc.). Each driver calls for a different mitigation strategy. Strengthening the MFI's recovery procedures will not reduce the risk of a drop in prices in an industry that the MFI has invested heavily in.

ARPs used internal management reports, internal audit reports, strategic plans, and financial data on losses as a basis for risk identification. Other sources for identifying institutional risk included external audit reports, consultant reports, donor evaluation reports, ALCO, and the *MicroSave* Toolkit itself (which lists common risks).

Measuring Risk

The importance of risk events varies according to the probability of frequency and impact of occurrence. These risk assessments should determine the priority with which an MFI allocates its resources to managing these risks. Whether the degree to which a risk is currently occurring within the organisation is considered a problem depends on the risk assessment and the related threshold.

MFIs need to answer the questions: Can an institution accept certain levels of risk? If so, what are those levels and how can they be measured? The symptom that a risk is occurring (high default rate) in turn becomes a possible indicator (PAR30) used to measure and monitor the level of risk. When a risk is being managed, it is likely that the symptoms will subside. In this manner, the symptom

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² See *MicroSave* Briefing Note No.23, Pikhholz and Champagne, "[Proactive Risk Management: Lessons for Microfinance Institutions](#)" available on *MicroSave*'s website in the Briefing Notes section.

³ See *MicroSave* Briefing Note No.23

becomes an indicator that risk exposure is reduced. While this is reassuring, it does not answer the question, have we managed this risk sufficiently?

The use of indicators is extremely helpful in answering this question. Without data, MFIs cannot manage risk and cannot devise appropriate controls. Risks can be measured quantitatively and/or qualitatively, and both types of measurements are needed in order to provide balance. The indicators must be relevant to what is being measured. The measurements selected should be valid, objective and verifiable. One ARP derived its risk indicators from its business plan for next year.

Data that is routinely and automatically collected as part of the MFI's on-going activities is the most accurate. Data generated by anecdotal methods does not guarantee valid and/or objective results. If a valid quantitative measure is not available, the MFI should consider developing a small research study in order to assess how well the risk is being managed. This would most likely be needed to understand customer-related risk events.

Criteria for selecting indicators

- Why are you measuring?
- What will you measure?
- How will you measure?
- Who will measure?
- Where will this be measured?
- When will this be measured?

Once the appropriate measure(s) have been decided, the MFI must set the threshold for its risk tolerance, remembering controls have a cost as well as benefit. An MFI may accept risk exposures up to a specified level, but above that threshold level, the MFI must take further corrective action.

If the risk trend is not decreasing and is still operating outside of the desired thresholds, the identified risk drivers must be re-examined. If the real cause of the risk event has not been properly identified, then the tactics are unlikely to be effective since they are addressing the wrong driver.

Institutionalising Risk Management

Senior management and the Board of Directors are responsible for risk management, but the actual administration of a risk management programme is delegated. It is a line function within the MFI's structure. Someone must be responsible for monitoring the risk management programme, ensuring that:

- Risk owners and high level monitors are reviewing their risks at the intended frequencies;
- Reviews in response to trigger events or special events are in fact performed;
- Risk measurements are taken, compared to thresholds and corrective action is taken if indicated;
- Risk policies and procedures are documented and updated; and
- Risk owners are sensitised and trained.

In short someone needs to be responsible for ensuring that the risk management feedback loop steps occur.

Who should be responsible depends on the size of the organisation. Larger organisations that face a complexity of risks should have their own Risk Manager, in a separate unit, department or group, who reports to the CEO and to the Board of Directors. The Risk Manager is a senior position within the organisation. As a result of the pilot, one ARP establishing a new Risk and Compliance Department, and will hire a Risk Manager specialist.

In smaller organisations, the Risk Manager may not be a full time job, but vested within an existing department of the bank. The question is, what is a suitable department? The Credit Department has often been the repository of risk management, and consequently has focused on just credit risk with respect to the loan portfolio, not even credit risk in its broader implications (e.g. settlement risk).

In some organisations, Internal Audit is responsible, as audit is concerned with risks and covers all aspects of the organisation. While Internal Audit is knowledgeable about risks and the organisation, it is also required to act independently and objectively; this it cannot do if it is also responsible for the risk management function. The table below illustrates the differing roles of Internal Audit and the Risk Manager. Another often-found solution is with the Finance Department, or within the Planning Department.

One ARP's ALCO will be the high level monitor, with the risk programme assigned to the Business Development Department. Another will form a Risk Management Committee, drawing largely on the pilot team members to constitute this committee. Wherever it is domiciled, the risk management function must be a comprehensive programme that includes all risks to the organisation, and someone must be clearly designated and held responsible.

Risk Management Role	Internal Audit Role
<ul style="list-style-type: none"> • Monitoring of Risks • Line Function • Administers Process 	<ul style="list-style-type: none"> • Identification of weaknesses with Risk Management process • Independent of all business processes • Reports directly to the Board of Directors

Conclusion

The risk management tools developed are dynamic, and change as the MFI cycles through the steps of the feedback loop. The *MicroSave* "Toolkit for Institutional and Product Development Risk Analysis" helps guide an MFI through the risk identification process, management, and measurement of their risks. Early indications based on the pilot test reveal that the tools, if rigorously applied, will help in the early detection and management of risks, especially in the development of new products.