

MicroSave Briefing Note # 23

Proactive Risk Management: Lessons for Microfinance Institutions¹

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Introduction

The increased emphasis on risk management in microfinance institutions (MFIs) reflects a fundamental shift among managers and regulators to better anticipate risks, rather than just react to them. Under Basel II banks must meet a series of qualitative standards including, the existence of an independent risk control and audit function and effective use of risk reporting systems.³

Proactive risk management is essential to the long-term sustainability of a microfinance institution. It lays out the general framework for identifying, assessing, mitigating and monitoring risk in the MFI as a whole. A key management responsibility is to provide reasonable assurance that the MFI's business is adequately controlled, and until it has embraced risk management at an institutional level, there is very little chance that the MFI's product-level risk management strategies can succeed.

Effective risk management has several benefits:

- **Early warning system for potential problems:** Less time fixing problems means more time for production and growth.
- **Efficient use of capital:** Risk management allows management to qualitatively measure risk, fine-tune the capital adequacy ratio, and evaluate the impact of potential shocks to the financial system or institution.
- **Successful new product development and roll-out:** Systematically addressing the risks inherent in new-product development and roll-out can result in enhanced corporate reputation, improved customer loyalty, easier cross-selling of services, and better knowledge for developing future business.

Risk management is either nonexistent or a fledgling process in most organisations. Rapid growth, new market and new product introductions, and major organisational and structural changes should all trigger an institutional risk analysis. Below is a brief discussion of some risk-management lessons,

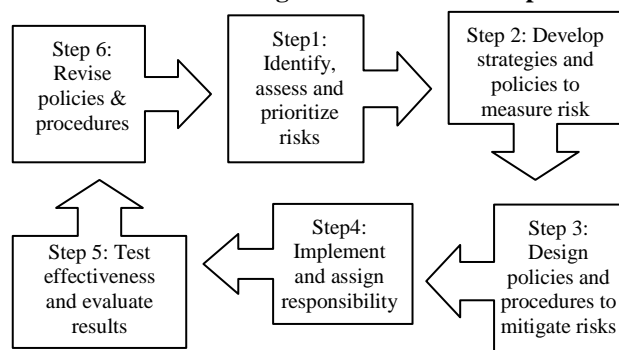
based on a review of four of *MicroSave*'s Action Research Partners. These institutions exemplify different institutional cultures, styles and maturity, and are facing different product development challenges.

A comprehensive approach to risk management reduces the risk of loss, builds credibility in the marketplace, and creates new opportunities for growth.

Organisational Change – Organisations deal with growth, new markets, new products, and other changes in a variety of ways, including recruiting new staff, hiring consultants, using cross-functional teams and outsourcing. The Project Management Process is a useful tool to help fast growing, resource-short organisations schedule multiple tasks and projects concurrently, prioritise human resources, and manage growth. Risks are better managed when there is a clear line of responsibility to a particular individual. The project management process also helps facilitate proactive management of product or project risks.

Proactive Risk Management – Most project development teams make two timing mistakes. One is waiting until late in the project before assessing and managing risk. Late discovery of potential problems precludes solutions that would have been available earlier and is more disruptive to the schedule, because less time is available to find solutions.

Risk Management Feedback Loop



¹This Briefing Note was prepared on the basis of the *MicroSave* toolkit: “Institutional and Product Development Risk Analysis Toolkit” available on *MicroSave*'s website: www.MicroSave.net under Toolkits section.

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³More information on the Basel II accord is available on the Basel Committee's website: www.bis.org

The second mistake is letting risk management lapse. MFIs are often very diligent at identifying risks and building some risk management deliverables at the early stage of the project. However, as they proceed to the 'real work' of product development they neglect risk management. As a result, when problems occur, they are in the same position as those who never identified risks. Good project management includes explicit risk identification and mitigation tasks at every stage.

Periodic Risk Management Reviews

Periodic risk management reviews and appropriate mitigation strategies can help organisations recognize signs of stress before risks get out of control. Signs of stress, however, can also indicate the failure of risk planning and mitigation. Typical signs of stress include high dropout, default, or turnover rates; an increase in subsidized funding; a decrease in the efficiency ratio; an increase in the average cost per loan; erratic cash management; and reported lapses in security.

Special Event or Significant Change Triggers

Significant changes within the MFI should also trigger an updated institution-wide and cross-functional risk analysis. Examples of special event drivers for risk management reviews include a changed operating environment, new product lines, new or revamped information systems, and rapid growth.

Counterparty Risk - It is important to identify stakeholders and third parties' that can have a strategic and often detrimental impact on the organisation's business, profitability and reputation early in the process. Strategies should be developed to mitigate this risk at an institutional level.

Human Resources - Many organisations focus on either the technical aspects of the product development process or the market product drivers, ignoring human resource issues until too late. This puts extraordinary pressure on budgets and the training department. Examples of risks associated with human resource management include insufficient or mismanaged staff resources; insufficient staff skills; a flood of new hires who may bring with them incompatible and/or undesirable cultures and methodologies; and loss of key staff.

Product Development - Because much of the effort that goes into new-product development is technical and systems-driven, there is a tendency to ignore non-technical risks. The opposite is true in customer and market-led organisations, which may pay less attention to operational and systems issues. Cross-functional teams are needed to provide both soft and hard skills during development⁴. Other issues to consider include communications, information systems, training, product costing and pricing, and internal audit and controls.

Guidelines for Setting up a Successful Risk Management (RM) Process

1. Lead from the top.
2. Incorporate RM into systems design.
3. Keep it simple.
4. Involve all levels of staff.
5. Align RM goals with individual goals.
6. Address the most important risks first.
7. Assign responsibilities and set monitoring schedule.
8. Design informative management reporting to board.
9. Develop effective mechanisms to evaluate internal controls.
10. Manage risk continuously using a risk management feedback loop.

Conclusion

The key to fulfilling the responsibility of providing reasonable assurance to stakeholders that the MFI's business is adequately controlled is the development of a comprehensive system of management controls, accounting and internal controls, security procedures, and other risk controls. MFIs committed to proactively managing risks need to establish a risk control structure which defines the roles and responsibilities of managers and board members with respect to managing risk.

Note: The risk management tools developed by the authors and *MicroSave* are evolving as we learn more from the field and as more MFIs give us feedback. The tools are particularly geared to comprehensive risk management and new product roll-out in MFIs. They can be found on *MicroSave*'s website www.MicroSave.net.

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⁴For more on the systematic product development process see *MicroSave*'s Briefing Note No.14 **Wright**, Graham A.N. "The Systematic Product Development Process" available on *MicroSave*'s website under Briefing Notes section.