MicroSave Briefing Note # 59

Institutionalising Risk Management for MFIs – Framework and Challenges

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Why Risk Management?

Risk management (RM) is an integral part of a financial institution's strategic decision-making process which ensures that its corporate objectives are consistent with an appropriate risk return trade-off. Risks taken should be identified, measured, monitored and managed within a robust, proactive and integrated risk management framework. In doing so, the institution seeks to avoid exposure to risks that are not essential to its core business and reduce its exposure to those that are inherent in its business. To this end, it should continuously adapt its risk management policies, guidelines, and processes to reduce exposure to risks within approved risk limits.

This Briefing Note is based on *MicroSave*'s experience in developing risk management policies within its Action Research Partners (ARPs).

Risk Management - A Paradigm Shift

Institutions seeking to adopt effective, proactive and integrated RM must address a number of aspects:

- *Oversight* shifts from management or lower to joint board and senior management stewardship in the form of active risk ownership and response at management level and in charters, committees, policy setting and board review activities.
- *Policies* for risk management become more formal and documented. All *MicroSave*'s Action Research Partners (ARPs) now have a risk policy and some have detailed risk manuals.
- *Scope of Actively Managed Risks* expands from primarily financial, regulatory and compliance risks to include all business risks.
- *Action focus* shifts from reactive or crisis management focus to proactive anticipation, monitoring and prevention.
- *Extent of involvement across the institution* expands from limited to involvement of most staff.

Scale and Complexity of Risk Management in MFIs

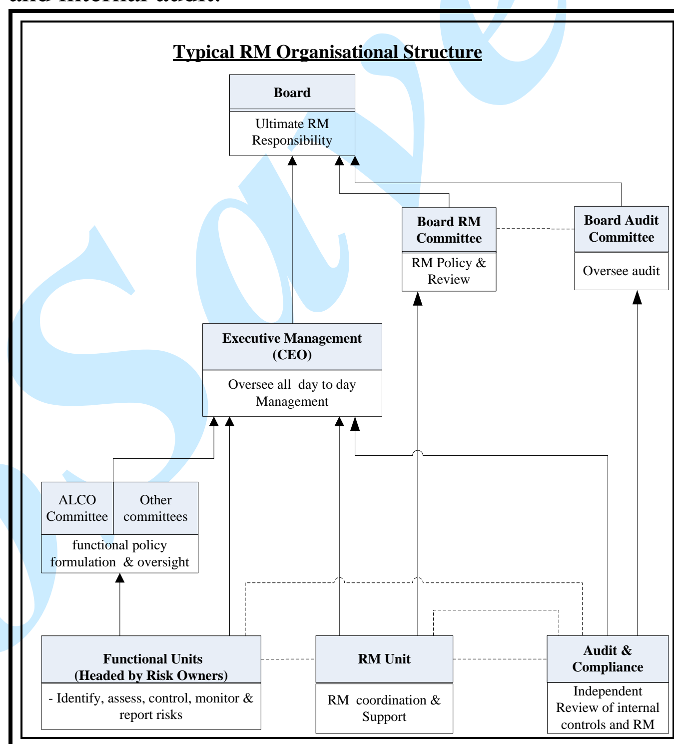
The complexity of a financial institution's risk management programme (RMP) depends on size, organisational structure, product range, regulation, the extent of regulatory requirements, the risk management skill set, the MIS and industry trends. Regulated MFIs are primarily subject to supervisory requirements (Pillar II) of the Basel II Capital Accords.

Components of a Risk Management Programme

Effective RM is achieved through a well structured Risk Management Programme (RMP). An RMP consists of several elements:

Strategy: Strategy includes agreeing and articulating objectives and direction, risk appetite, culture and risk management policy.

Structure: RM structure consists of skills and capabilities, board and senior management oversight, organisational structure, risk ownership, institution-wide roles and responsibilities, reporting structure and independent review and internal audit.



Processes: RM processes entail activities within the RM feedback loop: (Identification, Assessment/ Measurement, Mitigation (procedures & manuals and activities) and Monitoring / reporting). Key to this is issue escalation (red flags) and redress.

Infrastructure: Infrastructure consists of physical enablement for RM and includes MIS, controls limit structure and physical business continuity arrangements, for example off-site disaster recovery facilities.

Where Should the RM Function be Domiciled?

The ARPs adopted various alternatives in housing RM:

Internal Audit Department: FINCA's relatively strong audit department directed the setting up of RM. Whilst this may suffice as a starting point for an MFI, it should be devolved in due course as RM needs to be independently audited on a regular basis. The self-audit pitfall can be mitigated through regular external reviews.

Risk Management Committee: A management level RM committee such as adopted by U-Trust has the advantage of

cross functional constitution which aids objectivity. Its principal drawback is the fact that its business is conducted in scheduled meetings which may result in difficulty in sustaining a proactive approach.

RM as an Additional Role for a Functional Head: Kenya Post Office Savings Bank's (KPOSB) head of Business Development and Planning was tasked with day to day RM coordination. A functional head, for example the head of finance or operations, can effectively double as the head of RM provided s/he possesses the requisite RM skills, has time, and the management of risks in this unit is subjected to regular objective external reviews.

RM Department: Equity Bank has a RM department entirely dedicated to RM and reporting to the CEO and the board's risk committee. Whilst this is the ideal option, it may require considerable resource outlay which the MFI may not be able to expend. This should be considered on the basis of an objective cost benefit assessment as the institution grows.

Integrating Process Mapping & Risk Management

Equity Bank and KPOSB have experienced dedicated teams that regularly subject product and non product processes and procedures to risk based process mapping. Institutions can derive immense value from an RMP underpinned by institutionalised process mapping. Once risks associated with product, and non product related processes, are identified, the level of risks can be assessed and the extent to which the institution wants to mitigate these risks can be determined. Product risk management addresses risks beyond those in product processes.

Project Management

A number of the ARPs have had to reactively address significant increases in institutional risk caused by poorly managed IT implementations, running numerous projects at the same time and failing to pilot test new products. Projects can increase institutional risk and thus should be conducted through a well structured project management methodology. This includes a high-level project sponsor driving each project, assisted by a technical expert and team with scheduled activities and ongoing performance measurement against set goals.

Role of Internal Audit in Risk Management

A relatively strong internal audit function is a prerequisite in instituting effective RM. The role of internal audit in an effective RMP entails:

- Assessing the effectiveness of risk *identification*
- Giving assurance that risks are correctly *assessed (scored)* by management for prioritisation.
- Evaluating appropriateness and conformity of risk responses to the institution's policies.
- Reviewing *management* of key risks by managers and the resulting *controls* instituted.
- Evaluating the ongoing *monitoring* and *reporting* of key risks by managers to directors.

Risk Based Audit: The role of audit in institutionalising RM ideally necessitates transition from substantive to risk based approaches to auditing. Risk based auditing has a wider scope than traditional audit as it moves beyond financial, regulatory and compliance aspects to all business activities. Other implications include a shift from cyclical plan of audits to audit priority and frequencies determined by risk levels in risk registers compiled by management detailing pre-assessment of risk levels. Risk based auditing goes beyond confirming that internal controls are operating to providing opinion as to whether risks are being managed to acceptable levels.

Central banks are moving towards risk based auditing, but the institutions they are auditing have taken time to adopt similar approaches. Failure to present regulatory inspectors with internally audited risk assessments have resulted in cumbersome and unduly adversarial inspection exercises.

Typical Challenges in Setting up Effective RMPs

Strategy: Risk management is often seen as a regulatory requirement, rather than a strategic tool, resulting in limited buy in and understanding by staff. ARPs have had variable success in getting risk owners to actively manage risk and coordinate efforts in an integrated, team-based manner.

Structural issues: Ineffective board involvement and oversight often due to minimal financial management literacy, inadequate separation of functional departments, inadequate skills often exacerbated by scarcity of skilled people to recruit from the market are common structural impediments to setting up an effective RMP. Others include weak job descriptions and differentiation at both departmental and individual levels; poor institutional performance management systems and culture; and inadequate internal audit capacity. ARPs must further increase the capacity of audit to match its expanded role. This is evidenced by ARPs with a weaker function, where RM has lacked timely, objective review for the benefit of the board and other stakeholders.

Processes: Typical process weaknesses include inadequate functional operational policies and manuals and internal control environment. Whilst all the ARPs were able to enlist professional help to design structures, policies and manuals to satisfy regulatory requirements, few have been able to fully implement and actively update them.

Infrastructure: The ARPs are considerably challenged in ensuring adequacy of appropriate facilities and resources, for example MIS and business continuity facilities.

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