MicroSave Briefing Note # 121

Risk Management for MFIs - I

Soumya Harsh Pandey

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Introduction

Risk is inherent to any business entity and microfinance institutions (MFIs) are no exception. What makes risk management in microfinance more complex is the absence, or near absence, of traditional risk mitigation mechanisms like collateral and guarantees, as well as the high volumes of cash transactions conducted in remote locations. Moreover, many MFIs are mission-driven organisations and therefore prone to strategic and political risks that are unique to them and the clients they serve.

As MFIs continue to grow and expand, serving more customers and attracting more mainstream investment capital and funds, they need to strengthen their internal capacities to identify and anticipate potential risks, and thus to avoid unexpected losses and surprises.

This series of two Briefing Notes deals with integrating risk management in MFIs so that they can develop their own risk management framework and systems within the organisation. The current Note highlights how an MFI can identify and understand risks that it faces.

Risk Management and Internal Audit

With the increasing range and scope of definitions of risk management and internal audit, these functional areas seem to be converging. Further, risk management is often confused with the internal audit (IA) function as in many organisations IA is usually the starting point for the risk management function. FINCA and Kenya Post Office Bank are examples of organisations where the risk function is handled by the audit internal department.[1] However, there are conceptual and operational differences between the two functional areas. The table below highlights[2] some of the differences between these functions.

Risk Management	Internal Audit
Non Routine	Routine
Management	Clerical
Assessment	Procedural
Objective Based	Constraints based
Target Based	Compliance
What could happen	What has gone wrong
Proactive	Post mortem

Overall, at a conceptual level, risk management could be considered as a preventive tool for the management; while internal audit can be considered as a curative tool for the decision making of the Board.

Understanding Risk

Risk has two key dimensions – 'uncertainty' and 'impact'.[3] 'Uncertainty', is often estimated by assigning 'probability' (frequency of occurrence) of an outcome, often categorised as 'high', 'medium' or 'low'. The second dimension refers to 'impact' of an outcome assessed against a given objective/s. Impact can be either 'positive' (opportunities) or 'negative' (threats). The following box describes some of the risk terms that are used in designing risk management systems.
Risk in MFIs, like in other financial institutions, can be categorised under following broad categories:

Risk Area – Describes a certain risk control area which can affect operations
Risk Driver – The causal factor which results in risk
Hazards – These are the factors that influence Risk Drivers
Inherent Risk – This is the risk that existed before any risk mitigation, whether by the way of control or other means
Controls – Management tactics in place to mitigate the noted risk
Post Control Likelihood - Remaining likelihood that risk would occur if all the controls implemented work 100%
Post Control Impact - Remaining impact that a risk has if all the controls implemented work 100%
Residual Risk - Remaining risk after applying the control measures. It is a result of Post Control Likelihood and Impact
Destination Risk – This is the level of risk you want to achieve after implementing the controls

Operational Risk: Operational risks are the vulnerabilities that an MFI faces in its daily operations. These involve the risks arising out of people, systems, processes and external events.
Credit Risk: Essentially risks associated with lending money and not being paid back.

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[1] *MicroSave* Briefing Note#59 – Institutionalising Risk Management for MFIs
[2] Adapted from IRMI.com, viewed on 30/4/2012
[3] See *MicroSave's* Risk Management Toolkit

Financial Risk: Risks arising out of financial mis-management.

Institutional/Strategic Risk: Risks arising out of adopting inappropriate strategic choices.

Identifying Risks

Usually, the work flow of an MFI is organised under different departments. Identification of risks starts with each department listing the risks that it faces in its functional area. For example, the finance department can list down risks associated with the finances of the MFI such as interest rate risk, liquidity risk etc.

Similarly the other primary departments of an MFI like credit operations, savings operations, human resources, management information systems, business development etc. can identify and list down risks associated with the functioning of their department. The process of identifying the risks can be facilitated by holding department-wise workshops where key members of staff discuss and list down risks associated with their department.

Identification of risk associated with the governance and executive management of an MFI can be tricky on two counts. First, the deliverables are not as clearly defined as other departments; and secondly, because of the governance and management of the MFI may not be open enough to admit and define risk areas.

Wisdom Micro Financing Institution (S.C), is an organisation based in Ethiopia. *MicroSave*, supported Wisdom to set up its risk management function. As a part of the process of development of risk management systems, a workshop was conducted with the senior management team. This workshop resulted in the rapid identification and prioritisation of risks for each of the main departments of the organisation.

Risk Prioritisation

After risk identification, the next step is risk assessment, where the identified risks are prioritised on the basis of their importance. Prioritisation of risk is important as the objective of risk management is not to mitigate all risk, but rather to focus on key risks faced by the organisation.

As noted above, prioritisation of risks is done on two parameters – 'frequency' and 'impact' on the objectives of the organisation. However, this is often the most difficult part of the exercise since many risks are unique to each individual organisation and assessing risk against industry benchmarks is difficult. Furthermore, there may be cases where industry benchmarks are not available altogether.

Therefore, to decide on the risk priority some organisations delve deep into the previous audit reports to understand different issues faced by organisation and then link this with risk areas to decide on prioritisation on the basis of frequency and impact.

Growing Opportunity Finance (GO Finance) is an MFI working in Chennai, India. The risk department of GO Finance has categorised risks based on a 'rubic' developed by them. This 'rubic' is basically a matrix that helps to decide scores for the risks faced by the organisation based on their frequency and perceived impact on the organisation. The decision on the frequency and impact, and ultimately the risk score, were initially based on the audit reports. However, with time, greater analysis and better understanding, risk scores were further refined to develop a much more accurate picture of GO's risk environment.

Some organisations, however, follow a different approach whereby the department level workshop is not only used for risk identification, but also for risk prioritisation based on their own experience. Either of these methods, or a combination of them, can be used by organisations planning to set up and integrate up a risk management function.

Conclusion

This Note focussed on understanding the risk function and its difference from internal audit. It also looked at different types of risks, as well as understanding some basic risk terms, risk identification and risk prioritisation.

The areas covered in this Note are the key starting point for any MFI planning to set up risk management systems. Following this, the entire process of risk management starts and risk scores, management tools for monitoring risks, setting responsibilities, developing the risk management structure and risk management practices are defined.

The next Briefing Note # 122, "Risk Management for MFIs -II", in this series will cover the above aspects.