MICROFINANCE RISK MANAGEMENT HANDBOOK

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Chapter 1: Risk Assessment Framework

Most microfinance institutions are small and unprofitable, and they operate without systems that adequately reduce risk. Although the microfinance literature focuses on success stories, such as BancoSol in Bolivia or BRI's microfinance units in Indonesia, these organizations are exceptional. For microfinance programs striving to fulfill their **dual mission** of sustainability and outreach to the poor, CARE suggests implementing the risk assessment framework that addresses two agendas:

1. Financial Health
2. Institutional Development

A standard risk assessment of a financial institution typically addresses the first issue only. In assessing the financial health of a bank or other financial institution, one would consider the organization's asset and liability management, including credit risk, as well as operational risks such as fraud and inefficiency.

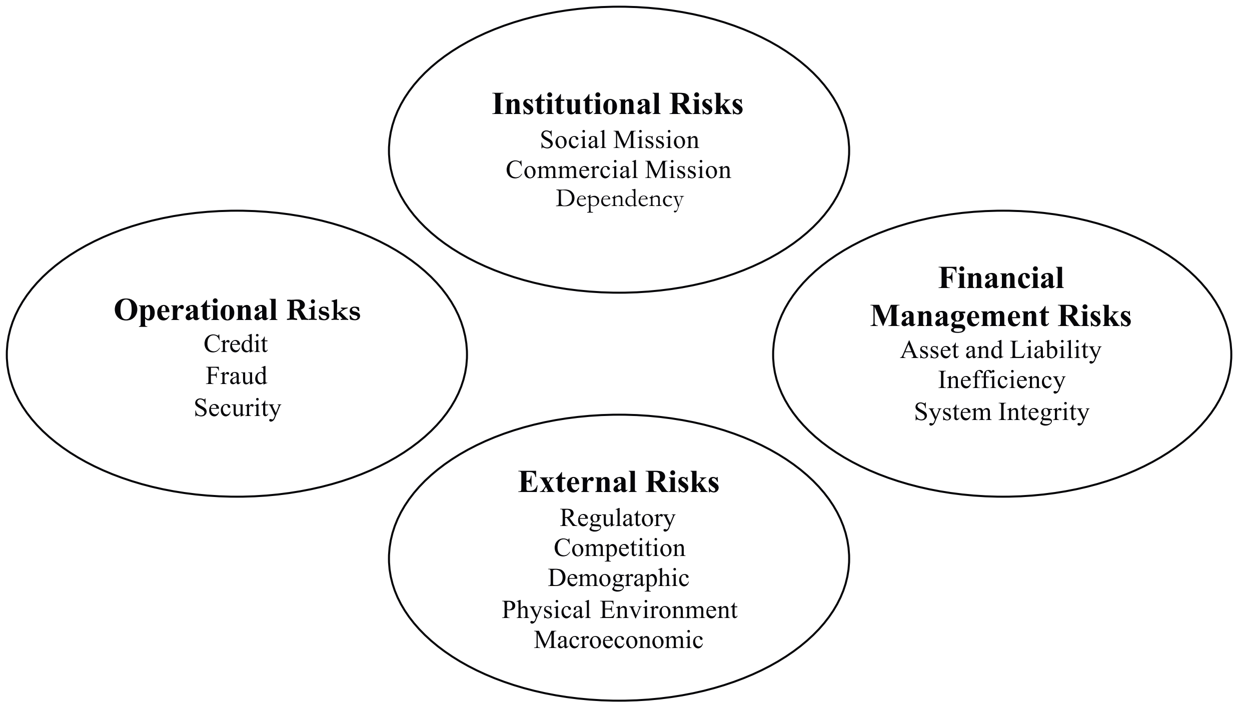
Microfinance risk assessment also needs to embrace an institutional development perspective. As MFIs evolve from donor dependency to commercial independence, clear vision, reliable systems, effective governance and staff capacity become critical in their ability to manage risk.

This integrated risk assessment framework for MFIs, which analyzes institutional development and financial health issues, is organized into four categories of risk: institutional, operational, financial, and external (see Figure 2). This framework provides *managers and directors* of microfinance institutions with a step-by-step means of assessing their organization's current and potential vulnerabilities.

1.1 Institutional Risks

Microfinance success is defined as an independent organization providing financial services to large numbers of low-income persons over the long-term. An assessment of risks against this definition results in three categories of institutional risk: social mission, commercial mission, and dependency.

Figure 2: Categories of Microfinance Risks



1.1.1 Social Mission

While all MFIs do not have the same mission statements, in general they have a dual mission: a social mission and a commercial mission. Their social mission is to provide valued financial services to large volumes of low-income persons that will enable them to improve their welfare. Microfinance institutions are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to their intended clientele.

1.1.2 Commercial Mission

The commercial mission of MFIs is to provide financial services in a way that allows the organization to be an on-going concern; that is, to exist for the long-term as a self-sufficient organization. MFIs are exposed to commercial mission risk if they do not set interest rates high enough to cover costs and if they are not managed as a business.

The social and commercial missions sometimes conflict with each other. For example, offering larger loans might make it easier to become sustainable, but this could undermine the social mission to serve low-income and harder-to-reach people who traditionally demand smaller loans. The microfinance challenge is to balance the social and commercial missions to achieve them both.

1.1.3 Dependency

Dependency risk is similar to commercial mission risk, but it is most pronounced for MFIs started and supported by international organizations such as CARE, particularly when the microfinance activities are operated as a project rather than as an independent organization. These MFIs are vulnerable to dependency on support provided by the external organization. While this support may initially seem like an advantage, it can significantly undermine efforts to build an independent institution that will exist for the long-term.

1.2 Operational Risks

Operational risks are the vulnerabilities that an MFI faces in its daily operations, including portfolio quality (credit risk), fraud risk and theft (security risk).

1.2.1 Credit

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern for MFIs because most microlending is unsecured (i.e., traditional collateral is not often used to secure microloans).

To determine an institution's vulnerability to credit risk, one must review the policies and procedures at every stage in the lending process to determine whether they reduce delinquencies and loan losses to an acceptable level. These policies and procedures include the loan eligibility criteria, the application review process and authorization levels, collateral or security requirements, as well as the "carrots and sticks" used to motivate staff and compel borrowers to repay. In addition to analyzing whether these policies and procedures are sound, it is also necessary to determine whether they are actually being implemented. The best policies in the world are meaningless if staff members are not properly trained to implement them or choose not to follow them.

1.2.2 Fraud

Any organization that handles large volumes of money is *extremely* vulnerable to fraud, a vulnerability that tends to increase in poor economic environments. Exposure to fraud is particularly acute where money changes hands. These vulnerabilities in a microfinance institution can be exacerbated if the organization has a weak information management system, if it does not have clearly defined policies and procedures, if it has high staff turnover, or if the MFI experiences rapid growth. The management of savings deposits, particularly voluntary savings, creates additional vulnerability in that a failure to detect fraud could lead to the loss of clients' very limited cash assets and to the rapid deterioration of the institution's reputation. In the detection of fraud, it is critical to identify and address the problem as quickly as possible to send a sharp message to staff before it gets out of hand.

1.2.3 Security

As with vulnerability to fraud, the fact that most MFIs handle money also exposes them to theft. This exposure is compounded by the fact the MFIs tend to operate in environments where crime is prevalent or where, because of poverty, temptation is high. For example, in high volume branches the amount of cash collected on a repayment day can easily exceed the average annual household income in that community.

1.3 Financial Management Risks

1.3.1 Asset and Liability

The financial vulnerability of an MFI is summarized in asset and liability risks, which include interest rate, liquidity, and foreign exchange risks. **Interest rate risk** rises when the terms and interest rates of the MFI's assets and liabilities are mismatched. For example, if the interest rate on short-term liabilities rises before an MFI can adjust its lending rate, the spread between interest earnings and interest payments will narrow, seriously affecting the MFI's profit margin. MFIs operating in inflationary environments are particularly vulnerable to this type of risk. **Liquidity risk** involves the possibility of borrowing expensive short-term funds to finance immediate needs such as loan disbursement, bill payments, or debt repayment. MFIs are most vulnerable to **foreign exchange risk** if they have to repay loans in a foreign currency that they have converted to local currency and therefore are earning revenue in the local currency.

1.3.2 Inefficiency

Efficiency remains one of the greatest challenges for microfinance institutions. It reflects an organization's ability to manage costs per unit of output, and thus is directly affected by both cost control and level of outreach. Inefficient microfinance institutions waste resources and ultimately provide clients with poor services and products, as the costs of these inefficiencies are ultimately passed on to clients through higher interest rates and higher client transaction costs.

1.3.3 System Integrity

Another aspect of financial management risk is the integrity of the information system, including the accounting and portfolio management systems. An assessment of this risk involves checking the quality of the information entering the system, verifying that the system is processing the information correctly, and ensuring that it produces useful reports in a timely manner.

1.4 External Risks

Although MFI managers and directors have less control over external risks, they should nonetheless assess the external risks to which they are exposed. A microfinance institution could have relatively strong management and staff, and adequate systems and controls, but still be prone to major problems stemming from the environment in which it operates. External risks are usually outside the control of the MFI, however it is important that these risks are perceived as challenges that the MFI should address, rather than excuses for poor performance.

1.4.1 Regulatory

Policy makers, banking superintendents and other regulatory bodies are becoming increasingly interested in, and concerned about, microfinance institutions. This concern is heightened when MFIs are involved in financial intermediation—taking savings from clients and then lending them out to other clients or institutions. Regulations that can create vulnerability in an MFI include restrictive labor laws, usury laws, contract enforcement policies, and political interference.

1.4.2 Competition

In some environments, microfinance is becoming increasingly competitive, with new players, such as banks and consumer credit companies, entering the market. Competition risks stems from not being sufficiently familiar with the services of others to position, price, and sell your services. Competition risk can be exacerbated if MFIs do not have access to information about applicants' current and past credit performance with other institutions.

1.4.3 Demographic

Since most MFIs target disadvantaged individuals in low-income communities, microfinance managers need to be aware of how the characteristics of this target market increase the institution's vulnerability. In assessing demographic risks, consider the trends and consequences of illness and death (including HIV/AIDS), education levels, entrepreneurial experience, the mobility of the population, social cohesiveness of communities, past experience of credit programs, and local tolerance for corruption.

1.4.4 Physical Environment

Some areas are prone to natural calamities (floods, cyclones, or drought) that affect households, enterprises, income streams and microfinance service delivery. In addition, the physical infrastructure—such as transportation, communications, and the availability of banks—in the MFI's area of operations can substantially increase its vulnerability.

1.4.5 Macroeconomic

Microfinance institutions are especially vulnerable to changes in the macroeconomic environment such as devaluation and inflation. This risk has two facets: 1) how these conditions affect the MFI directly and 2) how they affect the MFI's clients, their business operations, and their ability to repay their loans.

1.5 Conclusion

The management and board of a microfinance institution should consider each of the risks identified in this chapter as vulnerability points. It is their responsibility to assess the institution's level of exposure, prioritize areas of greatest vulnerability, and to ensure that proper controls are in place to minimize the MFI's exposure. The next four chapters' address the controls and monitoring tools required to manage each of these four categories of risk.

Figure 3: Organization of Microfinance Risks by Chapter

Chapter 2	Institutional Risks	Social Mission Commercial Mission Dependency
Chapter 3	Operational Risks	Credit Fraud Security
Chapter 4	Financial Management Risks	Asset and Liability Inefficiency System Integrity
Chapter 5	External Risks	Regulatory Competition Demographic Physical Environment Macroeconomic

Chapter 6 then presents the accounting and portfolio management systems required creating an effective risk monitoring system. The fact that it comes at the end of this document should not lessen its importance. The implicit basis for effective risk management is **transparency**. If an MFI does not have accurate and timely information that it can analyze through a variety of different lenses, then it cannot manage its risks. Chapter 6 provides guidance in how to enhance transparency through information systems.

The Ultimate Risk Management Controls: Good Governance and Quality Human Resources

This handbook contains a host of controls to mitigate the specific risks to which a microfinance institution is exposed. There are two overarching controls, however, that deserve special mention because they cut across numerous risks and serve as critical building blocks on which many of the other controls are based.

Good Governance: The board of directors plays a critical control function in a microfinance institution. *One of the board's key responsibilities is to analyze risks and ensure that the MFI is implementing appropriate controls to minimize its vulnerability*. This handbook is a valuable tool for directors to comprehensively review possible risks and to pinpoint the areas of greatest vulnerability.

Unfortunately, the microfinance industry is not particularly well known for its effective governance, which presents its own set of risks. In the search for effective governance, consider the following guidelines:

- The board should be comprised of a group of **external directors**, with diverse skills and perspectives that are needed to govern the MFI. The composition should balance the dual mission of microfinance, with some directors more concerned with the social mission and others focused primarily on the commercial mission.
- It is critical that board members dedicate **sufficient time** to fulfill their functions. It is not appropriate to appoint directors solely for their "political" value; while it might seem nice to have the names of famous people in the annual report, if they do not actually attend board meetings and play a meaningful role, then they are not providing good governance.
- There needs to be a clear **separation of roles** and responsibilities between the board and management. The board oversees the work of senior managers and holds them accountable, which includes setting performance targets and taking disciplinary action if necessary.
- The board should **meet often** enough to keep a close eye on the organization. During periods of change, this may mean weekly meetings. In mature, stable MFIs, quarterly meetings might suffice, especially if there is an executive committee of the board that is in more frequent contact with management.
- Boards should be **regularly rejuvenated** so that new ideas and fresh energy are injected into the organization. This can be accomplished through term limits and/or a performance appraisal system that encourages inactive and ineffective directors to step down.

Trained and Motivated Personnel: The other "building block" control is the MFI's employees. As a service industry, the delivery of microfinance products is just as important as the products themselves. An MFI can dramatically reduce its vulnerability to most risks if it has well-trained and motivated employees. This is accomplished through a three-pronged strategy:

- *Hiring*: The first step is finding the right people. In hiring field staff, you are probably not going to find people with microfinance expertise, so instead you should look for certain **values** (honesty, commitment to the target market, a willingness to get their shoes dirty), personality **characteristics** (outgoing, team player), and **aptitudes** (combination of "hard" and "soft" skills). Once you identify the ideal traits of a loan officer, then you can design your screening techniques accordingly. When you find a few of the ideal people, then figure out where they came from to see if there are more of them out there. Sometimes certain schools, religious groups or social organizations are excellent sources of new employees.

- *Training*: Once you have hired the right people, the next step is to train them well. Training often focuses on the nuts and bolts of doing a job—such as what forms do you fill out for what purposes—but to serve as an effective control, training should impart much more than just technical skills. New staff orientation is the ideal time to indoctrinate your employees, to bathe them in the institution's culture, to cultivate their commitment to the organization, its mission and its clients, and to teach and practice the social skills needed to perform their jobs, such as group mediation and facilitation, adult education, customer service, and time management. Training should not end once the loan officer hits the streets. To retain quality people, and to ensure that they grow and develop as the organization evolves, it is necessary to provide regular in-service training as well. In the search for increased efficiency, MFIs are constantly looking for ways to streamline operations and cut corners; they should resist any temptation to short-change the training of new or existing employees.
- *Rewarding*: It is difficult to keep employees motivated and enthusiastic about their work. MFIs should view their best employees the same way they view their best customers: once you have them, do every thing possible to keep them. An MFI that wants to retain staff needs to position itself as *the* employer of choice. This involves providing a competitive compensation package, but it is much more than just wages. Salaries are already the biggest line item in most MFI budgets—so it is necessary to find creative ways of rewarding and motivating staff. Other factors that influence an employee's satisfaction, and therefore their willingness to remain with the employer, include:

- Benefits such as health insurance and vacation time
- An institutional mission where people feel that they can make a difference
- Workplace design that is comfortable and conducive to productivity
- An institutional culture that is unique so that employees feel like they are part of a special team
- Recognition of individual and group accomplishments
- Staff development and job enrichment opportunities

Research Sites for Country Risk

- https://www.cia.gov/library/publications/the-world-factbook/
- http://viewswire.eiu.com/