A Road Map for Effective Risk Management in Deposit Taking MFIs in Laos PDR

1. Introduction

In August 2019, LAFF as part of its technical assistance initiatives, secured services of an international expert in Risk Management. The focus primarily was on a partner MFI to assess its risk management function, to recommend ways to strengthen current practices. A second objective of the assignment was to share the lessons with a wider audience of MFIs, as most critical issues are common in the industry and need to be addressed across the microfinance sector. This policy brief is a result of this effort.

The content of this brief is presented at the workshop 'Risk Management for Deposit Taking MFIs' held in Vientiane in January 2020 under the leadership of Bank of Laos, the project execution agency of LAFF and organized and coordinated by the Microfinance Association and AFC- LAFF technical team.

2. Why is Risk Management important?

Microfinance globally has been recognized as a key tool in addressing poverty and promoting enterprises. Its growth has been fast in terms of the clients and size of portfolios. This exponential growth has been made possible through innovation and out of box thinking which were revolutionary, compared to traditional banking.

Together with the growth came the associated risks and today the need for risk management in Micro and SME (MSME) financing is critical factor for the stability of the industry. This move has accelerated with the impact of the collapse of some leading MFIs and reporting of not-so transparent and irresponsible lending practices. Therefore, there is immense interest in risk management practices and the need to find solutions and risk mitigation measures, in order to avoid negative impacts on clients, as well as the industry.

Developments in Laos microfinance landscape is not very different and there are many lessons that can be learned from the international experience. By putting best practices into effective use, the poor who need access to finance and the industry, both could be guarded.

3. What risks in Microfinance?

Risks are events that is possible to occur, if materialized will make a negative impact. All risks are not losses but if not attended to in time, may result in a loss to the MFI. It is prudent to be watchful and take necessary preventive measures to stop such risks crystalizing into losses.

Risk is common to any business and there are no businesses that have eliminated it completely. However successful businesses, mitigate and manage the risks, through prudent policies and practices. This situation is very true in the case of financial service industry including in microfinance.

Microfinance Risks

The Risks common among Financial Institutions can be categorized as Financial, Operational and Strategic. The following table is a summary of such key risks in MFIs. Financial risk consists of Credit risk, liquidity risk and market risks that can lead to a financial loss. Operational results from vulnerabilities in transactions, human resources and frauds and Strategic risks consists of leadership or governance, reputation and external businesses.

4. Who is interested in Microfinance Risks?

Risks affect all who interact with microfinance operations and therefore, all who have any dealing with MFIs should be interested in understanding and managing the risks. Risks affects all of them not only one party and these include; the MFIs including staff, customers, funders and shareholders, competitors, depositors and regulators and supervisors, also the policy makers.

Stakeholders and their interests

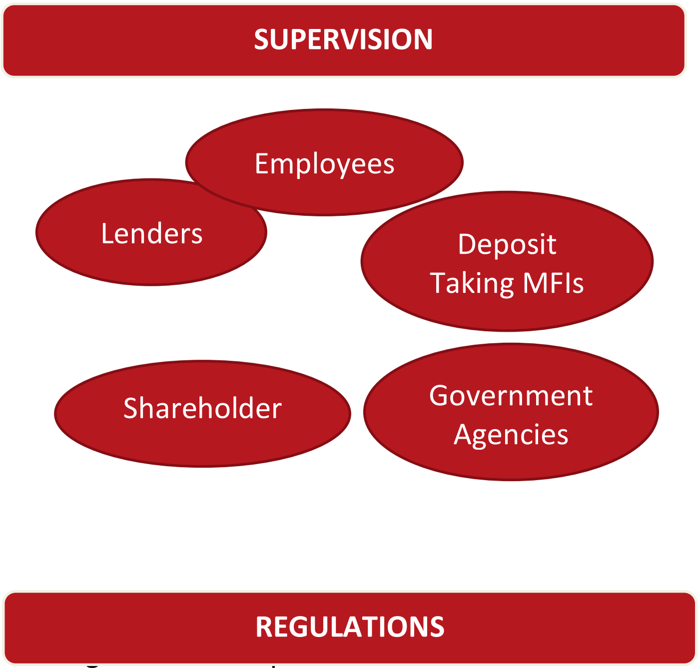
Stakeholders	Their Interest
Policy Makers	Impact on the poor, deposit makers, economic and political consequences
Regulators	Effectiveness of regulation
Supervisors	Effectiveness of supervision and accountability
Directors	Accountability and Compliance
Shareholders	Investment
Employees	Jobs
Borrowers	Access to finance
Depositors	Savings and investments
Lenders	Lending
Competitors	Market collapse, delinquency, loss on confidence in the sector

Their interest may be different or varying but they are all in one eco-system and in case of loss situation, such losses or impacts are infectious and spread widely and fast. Therefore, it is in the interest of all stake holders to work together to avoid such an adverse scenario.

To be effective in risk management, the entire sector should work together to address the common risks that can not be solved by an individual MFI. Therefore, there is a common responsibility among all to work together and in this process the regulators and supervisors play an important role as the guardians.

5. Regulation and Supervision

The prevailing regulations in Laos demand MFIs to comply with a series of requirements from the time of obtaining a license to do business, with the objective of mitigating risks in MFIs and the sector as a whole. There are many regulations that cover operations and particularly on how the business is governed. In addition to financial requirements, the regulations stipulate how the board should be constituted and its composition, who can be appointed as directors and the need to appoint independent directors, their responsibilities and duties, how they should function[1].



can not be managers of MFIs. These regulations are strict, and all MFIs are required to meet these conditions. The supervision plays a key role in ensuring all these regulations are complied with and have the power to sanction managers and directors of MFIs for non-compliance.

It must be noted like in other countries, the regulations in Laos are stricter for deposit taking MFIs, as the public deposits are involved as an added risk and responsibility.

6. How they manage Risks?

Risk management is not a one-time activity but a process and this process is called the Risk Management Cycle and can work at different levels, both at macro and micro level. The regulators and supervisors can follow a similar cycle as well as the microfinance institutions. Similarly, this applies to investors and lenders and even individuals. However, the individuals in their role of borrowers and depositor may not pay much attention to such and as a result, policy makers at national level, introduce regulations to safeguard their interests.

Risk Management Cycle

The Risk Management process involves managing the probability or the severity of the adverse event to an acceptable range or within limits set by the MFI. It should start with risk identification followed by measuring, designing policies and procedures, assigning responsibilities for implementing, regular evaluation and reviewing. This should not be

[1] Article 21 of Prime Ministers Decree on MFIs 460/G dated 03 October 2012

considered as a linear process with a start and an end. To be effective this should be a dynamic cycle and be in motion all the time.

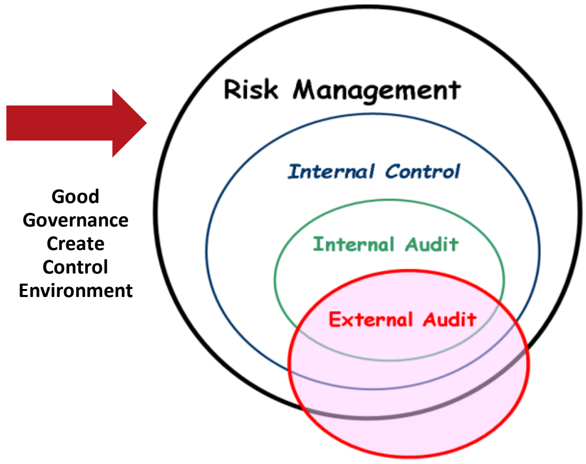
The risk management process provides preventive, detective and corrective actions to strengthen the overall function.

In MFIs, the risk management process should be well supported by Internal Audit and External Audit. These two functions are complementary and not mutually exclusive. As per regulations governing Microfinance institutions in Laos PDR, establishing an internal audit function and appointing an internal auditor is a key responsibility of the board of directors.

7. Risk Management Control Environment

Risk management is about proactively managing an institution's business. This approach should be ingrained at all levels of management and reflected in an MFI's processes and procedures. Risk management should not be viewed as merely a defense mechanism but as a tool that can enhance the MFIs credibility in the eyes of stakeholders.

It is important to have policies and processes in managing the risks at all levels. However, these will not be effective if the right control environment is created and maintained.



At the national and industry level it's the responsibility of the policy makers including regulators and supervisors to create and maintain that environment. In MFIs it's the responsibility of the board of directors. That's is why the role of good governance is critical in having an effective risk management.

8. Risk Management in MFIs

In MFIs, the primary responsibility for creating and maintaining a risk management environment and process lies with the Board of Director. The Prime Ministers Degree of 2012 and Implementation Guidelines by the Bank of Laos are very clear on this.

The board of directors should consist of 3-7 members including the chairman and an independent director and appointed only for a period of 3 years but possible to be re-appointed by the shareholders. Appointing an Internal Audit Committee and the internal auditor is a key responsibility of the board. It also clearly stated that their responsibilities could not be delegated, and they shall be held accountable for any loss to the DTMFI due to their inaction or negligence.

Internal Audit Committee will take the lead in developing and maintaining a risk Control

Environment within MFI and for timely external audits

The have a judiciary and regulatory obligations to do so, as stipulated in the regulations in the Laos PDR[2]. The board of Directors with the participation of senior managers should create a control environment which encompasses over all attitude, awareness and actions regarding the internal controls and actions

As previously mentioned, Risk Management is a process that should be viewed in whole, as risks are connected and permeates through all functions of a MFI.

9. Way Forward

Risk management in microfinance is a very important issue and the experience of the sector in Laos highlights the need for further strengthening. In Laos there is hardly any evidence of good risk management practices among deposit taking MFIs. This has created a huge social and economic burden on the society. This risk can lead to very negative impact on the poor in the country.

The responsibility of addressing this issue lies with all who are part of the industry. Among them, the regulators and supervisory authorities play a vital role. They provide guidance and supervision to ensure compliance. Their role should be equally complemented by good governance within MFIs.

For this the board of directors should understand their accountability and accept responsibility of developing good governance practices to ensure that the right environment is present. *The BoDs should take leadership in Risk Management. This will entail; updating their knowledge on regulations, rights and responsibilities, reviewing thier institutional governance and strengthening and re-establishing governance structure of their MFIs, comprising of Audit Committee, Internal controls, Efficient MIS and Business Planning.*

Lao Microfinance Association can play an important as the industry body. *LMFA should initiate leading industry wide information sharing on Risk Management and its importance, promoting best practices in Risk Management, playing the role of technical service provider.*

The supervisor FISD plays a critical role in developing good risk management practices in the industry and ensuring compliance by MFIs. However, there is still a strong need for a more strategic approach to this if short to medium term results are to be achieved. *FISD could lead in re-establishing industry level knowledge in Risk Management, establishing a regular dialogue with the industry and agreeing on a time bound action plan, recommending changes to regulation if required and supervising MFI compliance strictly.*

In summary, it must be stressed that MFIs and their boards should take the responsibility for establishing good risk management practices to safeguard all stakeholder interests but particularly, the depositors and the poor in Laos.

[2] Refer BOL Regulatory Requirements for statutory responsibilities of Director, how they should function and how organizational structure should be giving Internal Audit an independent function reporting directly to board sub-committee on Audit.