Microfinance Risk Management: current status in the Microfinance Industry in Uganda

Keynote by Mustapha B. Mugisa, CFE at the AMFIU Annual Conference at Hotel Africana, Kampala.

The Chief Guest, Hon. Minister of Finance, Planning & Economic Development

The President, AMFIU

All Invited Guests,

Ladies and Gentlemen,

What do you think is the impact to Uganda's economy when a business collapses? What happens when that particular business is a Microfinance institution?

The impact is catastrophic.

My Dad's best friend, Mr. Joseph Businge, used to own three shops and a restaurant in Masindi town. His wife, Beatrice, was an employee at Support Organisation For Microcent Development (SOMEDI) head offices in Masindi. They had five children in school who were very promising. Joseph was a successful man providing employment opportunities to other ten Ugandans working in his small businesses. He owed his success to SOMEDI Microfinance which gave him a small loan, through a group of five friends.

In 2008, SOMEDI Microfinance once one of the top Microfinance institutions in Uganda with operations in over eight districts, was no more. It suddenly collapsed.

Many people, including Joseph Businge, collapsed with it.

You need to visit Masindi and see for yourself the impact SOMEDI Microfinance had on the people in that area and beyond.

In 2012, I visited Joseph. If you were with me in his small sitting room, you would have seen first-hand how desperate poverty can make a man. Two of his once brilliant children were at home besieged by jiggers. After senior six, they dropped out of school due to lack of money for further education. Once a budding entrepreneur, Joseph and wife now do subsistence farming around their home and live in the worst of conditions.

SOMEDI was started around 1996 by a local entrepreneur. It expanded into a vibrant and model Microfinance attracting very good international partners who provided low cost funds for lending. It is unfortunate that SOMEDI collapsed with so much other people's money while shattering the lives of those who depended on it.

One of the past senior staff of SOMEDI attribute its collapse to poor governance, high levels of fraud and the lack of clear shared strategic focus.

Victoria Basin Savings and Microfinance Cooperative Trust Ltd (VBS) is another bad experience.

Currently under receivership, Victoria Basin Savings and Microfinance Cooperative Trust Ltd demise has heartbroken so many people. Founded in 1990, this once vibrant entity started operating as a building society and then transformed into a SACCO. It became an immediate success.

However, the change in the legal status called for better ways of doing things especially an effective and independent Board for oversight, risk management and going concern.

Unfortunately, its leadership and members did not respond to the new realities. It was reported that one of its founding members and the then General Manager in collusion with others stole over Ugx. 750 million from the institution through insider lending, false reporting, theft and bad loans thereby shattering the dreams and livelihoods of over 12,000 depositors in Rakai.

The institution was also reported to have a debt of about Ugx. 1 billion; far in excess of its identifiable assets valued at less than Ugx. 200m. With timely on-sight supervision by the regulator, this kind of exposure would have been identified and possibly prevented.

Any business that collapses leaves its stakeholders in a bad state.

Given the devastating impact of business failure, the need for sound governance is long overdue. Risk management is a key ingredient of sound governance practices.

I take this opportunity to thank The Association of Microfinance Institutions of Uganda (AMFIU) for dedicating this annual conference to risk management with a theme:

> *Managing risks in Microfinance – a critical challenge for the sustainability of the Uganda Microfinance industry."*

The industry will not succeed if you do not anticipate events that could cause its failure through establishing a clear strategy to manage the risks. Good risk management is critical to the long-term sustainability of Microfinance institutions.

Uganda's Microfinance industry plays a key role for the country's development. Microfinance is a business with the expectation on both social impact and economic return. It supports the people at the bottom of the pyramid to change their lives in a sustainable way. Majority of Ugandans are poor and live in rural areas. They are excluded from the formal banking sector due to the lack of collateral securities and bankable projects often required by mainstream financial institutions.

The status of Microfinance risk management in Uganda can be explained under two key areas – regulatory and governance.

Regulatory framework

The current structure (*Table 1*) of the Microfinance industry is such that majority of the players are outside of the formal regulation. This is a threat to the success so far attained.

Table 1: *Current status of the Microfinance industry in Uganda*

Tier	Category of Institutions	Regulation	Number
Tier 1	Banks	Bank of Uganda; Financial Institutions Act 2004	24
Tier 2	Credit Institutions		4
Tier 3	Microfinance Deposit-Taking Institutions	Bank of Uganda; MDI Act 2003	4
Tier 4	MFIs and SACCOs	The Companies Act, 1961	49
		The NGO (Amendment) Act 2006	81
		For SACCOs, the Registrar of Cooperative Societies (MTIC) under the Cooperative Societies Act Cap 112	2,065
		Informal: no clear regulation for other savings and credit schemes like savings and credit schemes in several companies.	Unknown
Other	Money lenders	Moneylenders Act, Cap 273, 1952	53

Source: AMFIU publications.

Note:
The semi-formal institutions are registered at the national level but are not regulated by the Central Bank and include Savings and Credit Cooperatives (SACCOs) and

other Microfinance institutions. The informal category combines all other community-based associations, including Village Savings and Loans Associations (VSLAs), Accumulated Savings and Credit Associations (ASCAs), and Rotating Savings and Credit Associations (ROSCAs).

Despite the critical role the industry plays, risk management is not adequately prioritised and managed to ensure long-term success through effective regulation and supervision.

As a result, there is a lot of mission drift by some Microfinance institutions in order to survive. Many Microfinance institutions are operating as businesses and in the processes competing with those they are supposed to help. As interest on microloans becomes very expensive, the beneficiaries cannot make profits they need to get out of poverty.

This kind of freewheeling is distorting the industry and must be stopped through effective regulatory and supervisory framework.

> *The success of Microfinance is not about making a lot of profits or expanding into a bank. That would be missing the point. It is about expanding scale and capacity to extend very low cost microloans to as many poor people as possible and enabling their enterprises to grow.*
>
> *It is also not just about making few 'winners' and sticking with them.*
>
> *It is a vicious circle of supporting poor people into winners and going back to support more poor people into winners, again and again…*

Mission drift and fraud are indeed big risks.

Take the case of Pearl Microfinance. PEARL (Promotion of Economic transformation And Realization of sustainable Livelihood) was originally founded as a part of Feed the Children Uganda (FTCU). It grew into one of the leading microfinance institutions in Uganda. It is bad news that the Microfinance suddenly closed down.

PEARL is said to have grown its portfolio and built capacity from donations, grants and loans from a large variety of partners including Canadian Feed The Children, SUFFICE, STROMME Foundation, Action Aid Uganda/European Union, ECLOF, Microfinance Outreach Plan, USAID- PRESTO, SPEED projects, Microfinance Support Centre, OIKO Credit, Kiva, and Post Bank.

After 12 years working as the community-banking department of FTCU, Pearl spun off to work as a for-profit microfinance institution in July 2006 when it was registered as a company limited by shares. Following an extra ordinary meeting held on 15th May 2013, the Directors of the institution resolved to voluntarily wind up the company's operations in Uganda. ''All the company's clients in respective branches should continue to service their loans through Stanbic, Post Bank and Centenary Banks'', read the statement in part.

The company has had financial problems for last two to three years. Pearl also had problems in 2011 and 2012, when the Uganda Shilling significantly devalued against the US Dollar. Pearl, used to get loans in US Dollars, and gave them out as loans in Uganda Shillings. This affected their profitability and services. With headquarters in Kalerwe, a Kampala suburb, the institution boasted of about 15 braches including Ntungamo, Kihihi, Kyenjojo, Mubende, Rukunguri, Ibanda and Bushenyi. You cannot imagine the negative impact this closure has had on the economy. Pearl Microfinance offered a number of services including micro leasing and loan products such as education loans, housing loans and salary loans.

I take this opportunity to appreciate the role of Ministry of Finance, Planning and Economic Development (MoFPED) which is mandated with policy and oversight of the financial sector and promotion of inclusive financial services, especially administration of programmes such as the Rural Financial Services Programme (RFSP).

I also acknowledge the good work of The Department of Cooperatives in Ministry of Trade Industry and Cooperatives responsible for policy, registration and supervision of SACCOs alongside other cooperatives. It has done a commendable job particularly working through the District Commercial Officers (DCOs) in the respective District Local Governments in Uganda.

This is commendable progress and points to brighter future.

Already, the process of establishing *Tier 4 Regulatory Framework* is in underway.

The proposals before Cabinet are to have Tier 4 financial institutions placed under prudential regulation and non-prudential regulation depending on their respective sizes. SACCOs classified as large shall be placed under prudential regulation but retain their cooperative nature, and probably regulated under an amended MDI Act.

The Ministry of Trade, Industry and Cooperatives (MTIC) is to retain the responsibility of registering SACCOs. The responsibility to license and supervise them as financial institutions shall be borne by a Regulatory Authority to be established under the MoFPED.

The Microfinance industry in Uganda is changing at fast pace.

We have got non-SACCO Microfinance institutions that have evolved from NGOs. There are also Wholesale lenders like Stromme, Microfinance Support Centre and Oikocredit which operate through several partner organisations including SACCOs. The Uganda Central Cooperative Financial Services (UCCFS) which exclusively serves cooperatives is another case in point.

New dynamics like mobile money transfer, mobile savings and microcredits via mobile phones add new complications to the equation.

All these developments call for an independent Regulatory Authority and a new law for timely supervision and user protection.

Governance framework

Risk management is a key component of the corporate governance arrangements in any institution. Unfortunately, there is a big difference between governance practices on paper and governance in practice in many Microfinance institutions surveyed for this paper.

Take the case of the defunct SOMEDI Microfinance. A former member said that "the Board was in place just to fulfil their statutory requirements to have a Board as manifestation of sound governance practices."

> *The reality on ground is microfinances are putting in place the Board, the internal and external auditors and 'systems' in place not providing appropriate funding, training, and tools needed to ensure those institutions or systems to work effectively.*
>
> *To the public and partners, the institution is ok, because it has the Board or auditors in place. On a closer look, majority of the Board members are neither independent nor appropriately qualified to provide proper oversight and risk management to ensure going concern.*
>
> *The lack of an independent Board with qualified members is the topmost threat to the success of many microfinances in Uganda.*

Risk management is an important aspect of the day-to-day operations of a Microfinance covering all activities i.e. operations, technical and strategy. It entails early and aggressive risk identification through the collaboration and involvement of **all staff** and other relevant stakeholders. Strong leadership and executive involvement is critical.

To ensure risk management culture, ownership and effective implementation, a collaborative and consultative approach must be adopted in the development of the *risk management strategy* to enable proactive identification of critical events that could impact on the specific Microfinance institution's key result areas (KRAs). Effective implementation of the risk management strategy must enable achievement of the key result areas as spelt out in the institution's strategic plan.

The fact on the ground is that risk management function is not structured in many Microfinance institutions.

During my survey, it was found that many microfinances have generic sets of identified risks like "credit", "liquidity", "technology", and "governance", among others without a structured methodology on how the risks are identified, assessed, managed and continuously reviewed.

Although some microfinances have risk management policies and strategies in place, majority of staff, including senior managers and the Board do not understand their roles in the effective implementation of those policies.

All employees must understand the nature of risk and accept responsibility for risks associated with their area of operations. Risks should be managed at the respective level they arise. It is common to find a Microfinance having the exact risk register of another! This is a case of failed risk management implementation.

As the case of SOMEDI and VBS Microfinance institutions have shown, fraud is the biggest threat to the survival of many Microfinance institutions in Uganda. Why is it that few institutions have recognised this and faced it wholly through on-going fraud awareness, establishing whistleblowing and clear fraud management strategies?

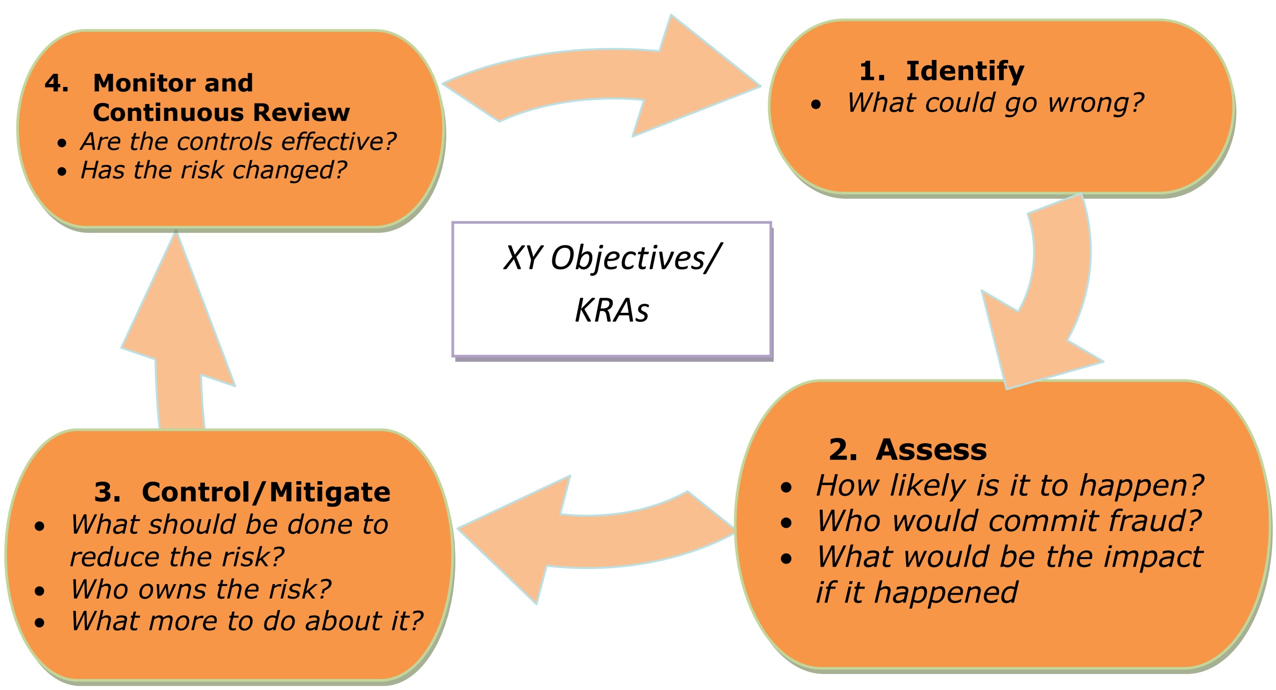
XY Microfinance's approach to risk management is a good model to adopt.

At XY, eight key questions are asked and answered:

First, do the Board, management and staff all understand how the risk register is developed or do they just see a final document?

To address this, they have a risk strategy in place that outlines the risk management methodology as shown in *figure 1* below:

Figure 1: Risk management process at XY



*Source: **Practical Risk Management: a step by step guide** book to be published in early March 2014 by Mustapha B. Mugisa, CFE.*

Everyone is asked "what could go wrong" at their departmental level using the top-down approach. Each identified event is assessed, appropriately controlled and continuously evaluated.

Second, is the Board involved in risk management?

XY ensures a right tone at the top throughout the process.

Third, for each identified event, are *likelihood* and *impact* clearly defined and appropriately assessed by process owners?

XY uses the likelihood and impact guide by the *Institute of Risk Management (IRM), specifically follows the ISO 31000:2009 guidelines as in tables 2 & 3 below.*

***Table 2: Event likelihood –** what is the likelihood of the event's occurrence?*

Rating	Score	Threat	Opportunity
Frequent	5	• > 75% chance of occurrence • Very regular occurrence	• Favourable and frequent occurrence likely.
Likely	4	• >50%< 75% chance of occurrence • Circumstances frequently encountered	• Favourable outcome is likely to be achieved in one year. • More than 50% chance of occurrence.
Possible	3	• >25% <50% chance of occurrence • Likely to happen at some point in the next 2 years. • Circumstances occasionally encountered.	• Reasonable prospects of favourable results in one year. • 25% to 50% chance of occurrence
Unlikely	2	• > 5% < 25% chance of occurrence • Only likely to happen once in 3 years. • Circumstances rarely encountered.	• Some chances of favourable outcome in the medium term • 5% to 25% chance of occurrence
Remote	1	• Less than 5% chance of occurrence. • Has never happened before • Circumstances never encountered.	• Less than 5% chance of occurrence.

Table 3: Impact of event- *what will be the impact on business if the event occurs?*

Rating	*Definition*	*Monetary Impact (Ugx'm)*	*Consequence*	*Impact on XY's objectives*	*Reputation per event*	*Non compliance*
5	Very high (catastrophic)	> 50	Leads to termination of projects or withdrawal of financing and is undamental to service delivery	Non achievement of objectives; performance failure	Maximum high headline exposure; Board censure; loss of credibility	Serious wilful breach; criminal negligence or act; prosecution; Board censure.
4	High (Critical)	> 10 < 50	Event which may have a prolonged negative impact and extensive consequences	Significant delays; performance significantly under target	Headline profile; repeated exposure; Board involvement; regulatory enquiry	Deliberate breach or gross negligence; formal investigation; disciplinary action; Board involvement
3	Moderate	> 5 < 10	Event which can be managed, but requires additional resources and management effort	Material delays, marginal under achievement of target performance	Repeated non headline exposure; slow resolution; Parliamentary enquiry/ briefing	Negligent breach; lack of good faith evident; performance review initiated
2	Minor	> 0.5 < 5	Event can be managed under normal operating conditions	Inconvenient delays	Non-headline exposure, clear fault settled quickly; negligible impact	Breach; objection/ complaint lodged; minor harm with investigation
1	Insignificant	< 0.5	Consequences can easily be absorbed under normal operating conditions	Little impact	Non-headline exposure, not at fault, no impact	Innocent procedural breach; evidence of good faith; little impact

Fourth, are risks appropriately identified and managed?

XY uses the following risk matrix for each identified risk event.

XY Risk index = impact x likelihood

IMPACT					
5	5	10	15	20	25
4	4	8	12	16	20
3	3	6	9	12	15
2	2	4	6	8	10
1	1	2	3	4	5
	1	2	3	4	5
	LIKELIHOOD				

Score	Risk magnitude
20 - 25	**Maximum**
15 - 19	**High risk**
10 - 14	**Medium risk**
5 – 9	**Low risk**
1 - 4	**Minimum risk**

Based on the above, XY has a risk universe of the key risks and their dependents to ensure effective monitoring as follows:

Figure 2: XY's risk universe

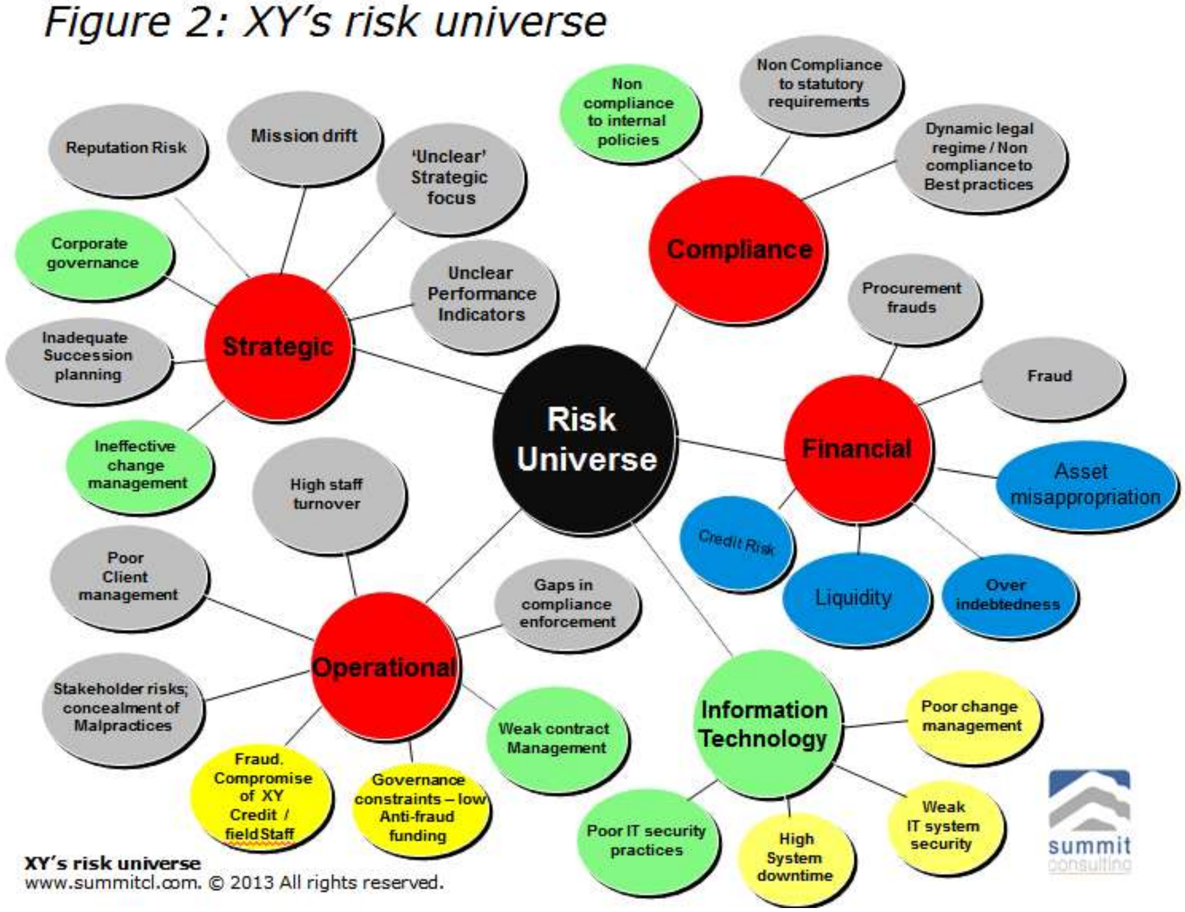
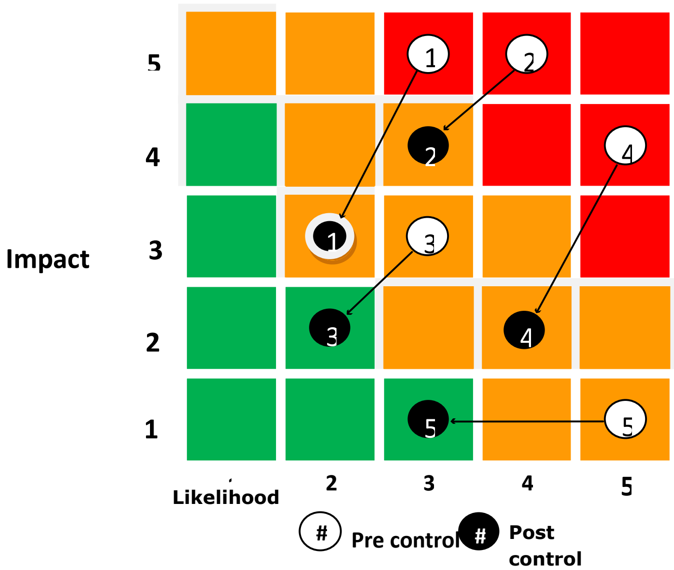


Figure 3: Risk Impact/Likelihood control



XY management then determines the acceptability of the risk and actions to eliminate, reduce, monitor and control them.

Fifth, are risk reporting process effective?
XY has effective risk reporting system in process where risks are reporting and escalated to the relevant office.

Sixth, has the board set and communicated risk appetite?

XY has clear risk appetite in place, as follows:

Risk class	***Board/ SMT/ management level articulation of risk appetite.***
Strategic	1) Zero tolerance of activities not within the Company's business plan and strategic objectives. 2) Very Low risk appetite for reputational risks 3) Zero tolerance for disclosure of confidential or classified information.
Compliance	1) Zero tolerance for non-compliance
Financial	1) Zero tolerance for fraudulent /theft activity by any staff, customer or stakeholder
Operational	2) Low risk appetite for inadequately trained, inexperienced and unskilled staff. 3) Low operational risk appetite for any internal process failures.

Risk class	***Board/ SMT/ management level articulation of risk appetite.***
Information Technology	1) Zero tolerance for use of unlicensed or out-dated software or program on any of the Company's computers or laptops. 2) Zero tolerance of IT & data security breaches. 3) Very low appetite for business outages or downtime for more than 1 hour.

Seventh, are top 10 risks identified and clearly monitored?

XY has operates a risk management software which provides a dashboard for easy risk monitoring. The software shows a risk register as follows:

Table 4: XY's Risk Register

Risk Description / Risk Event Statement	Responsible	Date Reported day-month-year	Last Update day-month-year	Impact 5 / 4 / 3/2/1	Impact Description	Probability 5 / 4 /3/2/1	Risk Index (impact x probability)	Status of Response N / P / PE / EE	Control/s and control description	Planned Future Actions/ controls in place	Risk Status Open / Closed / Moved to Issue
A risk event statement states (i) what might happen in the future and (ii) its possible impact.	Title of team member responsible for risk	Date the risk was first reported	Date the risk was updated	5-VH, 4-H, 3-M, 2-Mi, 1-In	List the specific impact the risk could have on the project schedule, budget, scope, and quality. Other impacts can also be listed	5-F, 4-L, 3-P, 2-Un, 1-R	20-25 Max 15-19 HR, 10-14 Med, 5-9 LR, 1-4 Min	N (No Plan); P (Plan but not enacted); PE (Plan enacted but effectiveness not yet known); EE (Plan enacted and effective)	All actions taken to respond to the risk.	What will be done in the future to respond to the risk	Open (still might happen& still has to be managed); Closed (has passed or been mitigated); issue(risk has happened)
KRA: IT											
Operational Risk; Poor IT system change management and project implementation	Head IT	xx	xx	5	-System down time; dissatisfied customers -Fraud potential	4	20	P; Project management plan in place. Project steering committee effective & project on schedule	-post milestone review by independent party -IA well-resourced to audit system	Post implementation review by independent team	Open

Eight, is our risk register up to date?

XY has a risk champion who ensures that the risk management process is on-going, and the risk register is up to date.

To access risk management software, visit www.risk.summitcl.com username: user password: user

The sustainability of the Uganda Microfinance industry is dependent on the regulatory and good governance. Managing emerging risks shall be the difference between success and failure.

Fraud risk is one of the single biggest risks for the financial industry and Microfinance institutions are not spared. There must be industry-wide efforts to address this challenge. The survival of the Microfinance industry in the near future remains in a balance unless risk management, especially the risk of fraud is adequately recognized and managed.

Automation is the future of every business. All Microfinance institutions must undertake on-going security training to their staff so as to mitigate the risk resulting from system failures and exploitation of security vulnerabilities.

Donors must become business partners and provide support beyond enabling outreach. There is need to support on-site capacity building as opposed to seminars. Practical skills are exchanged at one's place of work and not in seminars. People working in microfinances at all levels must be shown how to set up and sustain good systems and structures instead of 'how good things look like on paper." On this end, donors and other partners should set up a practical skills transfer fund managed at either AMFIU whereby the experts have time to visit company by company to understand their challenges and help implement best practices.

Government must fast track the law for regulating Microfinance institutions, SACCOs and all other sector players. This will give clear guidelines on the classification of the different Microfinance players. Many organizations have in-house staff managed "savings and loan schemes." How are these different from cooperative societies? Many Microfinance institutions are outside the main stream regulation and is a big set back to the sector. At what stage should a Microfinance institution upgrade to an MDI or to a Bank, just as we have seen Faulu Uganda transform into Opportunity Bank?

Government of Uganda should take advantage of the existing institutions that have exhibited good governance practices in standard setting and self regulation. Institutions like Association of Microfinance Institutions of Uganda (AMFIU) and Uganda Cooperative Savings and Credit Union Ltd (UCSSU) may be provided for in the new bill instead of starting from scratch.

Ends

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