ENTERPRISE - RISK MANAGEMENT FRAMEWORK

PETRA MICROFINANCE BANK PLC

Table of Contents **Page**

ABSTRACT
Robert S. Kaplan warned that a company's ability to weather storms depends largely on how seriously top managers take their risk management functions when the sun is still shinning and no clouds are on the horizon. Managing risk is different from managing strategy. While risk management focuses on the negative threats and a failure against the achievement of the organization's set objectives, business strategies are about proactive decisions to maximize future opportunities and successes.

Microfinance banking in Nigeria is a unique financial services sub-sector recovering from the peculiar nature of distrust by the public and depositors in recent times. So despite all the rhetoric, time and cost made on capacity building programmes by the regulatory bodies to repositioning this sub-sector, risk management is often treated as a compliance issue that can be solved by drawing up rules, making sure that employees comply appropriately. Many such rules are necessary and do reduce some risks which had previously damaged the microfinance banks in their markets. In fact, empirical data by regulating bodies showed that one of the major causes of the large failure of MFBs was the huge bad debts arising from the failure of management to take their credit risk management functions very seriously.

1. INTRODUCTION TO RISK MANAGEMENT
Risk taking is an inherent and integral part of financial services in general and of microfinance banking in particular. Indeed, profits are in part the reward for successful risk taking in business while excessive and poorly managed risk can lead to losses and endanger the safety and soundness of the institution. Consequently, Petra Microfinance Bank Plc. (the Bank) may fail to meet its social and commercial objectives. This implies that proactive risk management is key to the long term financial sustainability of the Bank. It is strongly believed that an effective risk management framework allows the Bank to take advantage of new opportunities and to minimize threats to their financial viability. Therefore, the Bank will place a significant emphasize on the adequacy of an institutional management risk framework. The top management is expected to focus on the bank's ability to identify and manage future risks as best predicator of long term success of our financial institution.

1.1 The Concept: A Risk Management Framework
This policy document focuses on the importance and value of risk management to The Bank and the methodology for designing a framework to managing the risks faced by the Bank:

- This framework is set out to on how to determine risk identification, measurement, monitoring and control system that will enhance risk management practices and effective awareness by all the Bank's employees.
- Management is expected to observe the prescribed guidelines in the process of our risk management system in conducting our core microfinance operations.

- The Internal Control officer is expected to apply risk based internal audit to ensure the effectiveness of the risk management process.

1.2 Why Risk Management is Important to Petra Microfinance Bank Plc

An effective risk management framework will protect the Bank's capital and earnings without hindering growth. Furthermore, investors will be more willing to invest in the Bank when they observe that it has good risk management practices. This generally results in lower borrowing costs, easier access to capital for the Bank and improved long-term performance.

The first step in creating an effective Enterprise Risk Management Framework is to understand the qualitative factors among the types of risks which Petra Microfinance Bank Plc. is exposed to. Three types of generic groupings are considered, namely:

I. **Preventable Risks:** These are internal risks. They are controllable and ought to be mitigated against. Examples are the risks from loan officers' non-compliance with the loan disbursements pre-conditions to draw down and the CEO's unethical or inappropriate actions in granting loans in disregard to the bank's Credit Policy Manual duly approved by the Board of Directors. Others include the risk from breakdowns in routine operational procedures, employees' attitudes towards the desired institutional core values and poor customer service delivery.

II. **Strategy Risks:** Banking is a highly regulated business with high risk probabilities. Therefore, the Bank's management voluntarily accepts some risks in order to generate superior returns from strategic decisions when micro-loan offers to borrowers are made under the Bank's terms and conditions where:
   - A strategic risk will evaluate the inherent benefits before taking such a high risk and match the expected returns against the risk exposure. Managing such risk is a key factor in capturing the potential benefits.
   - An effective risk management framework will put in place alternative action plans to take should those risks occur. Microfinance Banks that does well take higher risks ventures within the regulatory framework than their competitors with less effective risk management practices.
   - With an ERMF Petra MFB will ensure that its **capital adequacy ratio is sound** enough in order to proactively guarantee its financial sustainability and satisfy its stakeholder's interests.

III. **External Risks:** These are risks outside the Bank's control. It includes regulatory policy inconsistency, state government policies. Managers should focus on their identification and mitigation of their impacts through their strategic risk management.

1.3 The Role of Leadership in Enterprise Risk Management Framework: Leadership plays a key role in Enterprise Risk Management Framework. Hence, risk management practices should begin from the Chief Executive Officer down the ladder to the security staff. Risk mitigations are about alternative causes of actions to be taken should the identified risks or threats occur. Therefore, the top management functions of the Internal Auditot should be distinct from the Head of Marketing to enable the risk bearer continuously identify, measure, control and influence the bank's risk profiles while working side by side with the other top management staff whose activities are generating new markets and more risks – and, if all goes well, ensuring sustainability.

2. RISKS AND CHALLENGES OF PETRA MICROFINANCE BANK - Risk refers to the possibility that the outcome of an action/business decision could bring up negative impacts/results to the organization:

- The outcome could either be a direct loss of earnings or capital.
- It could be an imposition of limitations on the bank's ability to meet its business objectives.
- The constrains could limit the bank from taking advantage of future opportunities.

2.1 MAJOR RISKS FACED BY THE BANK: The major risks faced by the bank include the following:

2.1.1 Strategic risk

- A strategic risk will evaluate the inherent benefits before taking such a high risk and match the expected returns against the risk exposure. Managing such risk is a key factor in capturing the potential benefits.
- This framework recommends alternative action plans to take should those risks occur. The Bank is risk adverse but whenever it takes risk, the Directors and management make sure they are calculated risk and that they are taken within the regulatory framework.
- The Bank in line with ERMF ensures that its **capital adequacy ratio is sound** enough in order to proactively guarantee its financial sustainability and satisfying its stakeholder's interests.

2.1.2 Credit risk,

The Bank under the tutelage of the Board Credit Committee (BCC) ensures that there exist a comprehensive ***Credit Policy Manual*** which clearly provides the guidelines to all the officers of the bank who are involved in the credit processing, administration and control. Suffice to add that the credit policy is duly approved by the Board. Consequently, all credit actions are in full compliance with the Credit Policy Manual**.** In keeping watch over credit risk, any exceptional transaction that is not clearly stated in the Credit Policy Manual is referred to BCC and subsequently to the Board for consideration/approval.

Credit Risk could result to any of the following consequences:

- Risk of Loan loss
- Principal Loss
- Interest Loan Provisioning

- Capital charge and reduction in your shareholders' capital unimpaired by loss.

Therefore, the Bank always ensures proper and full credit documentations in line with CBN regulatory guidelines that micro-credits above N50, 000.00 should be fully collateralized. This is in addition to the below creative credit risks transfers' tools:

- **Third Party guarantee** fully supported by realizable security.
- **Group Lending** to all the economically active poor is supported by Cross Guarantees by the respective group members.
- **Substituted Collateral for Micro loans Processing.** This commitment security is provided by all loan officers booking loans into the loans portfolio. It provides management the evidence the credit risk originator or risk driver responsible for the full liquidation of the risk should it finally occur. Because this is institutionalized, the risk driver becomes a pressure tool on the borrower to pay as agreed. The Md/CEO enforces this policy prior to any credit approval.
- **Staff Employment Guarantee -** to hold such guarantors obligations to all demeanors created during their engagement in the bank.
- **Staff motivational incentives** against fraudulent intentions.
- **Fidelity Insurance** against employee willful thefts on customers' deposits placed in their care.
- **Board Credit Committee:** All credit applications must be forwarded to this Committee by the Head of Credit & Marketing chaired by a Director for review and further actions.
- **Head, Internal Control:** Verifies all credit Information after the credit appraisal by the Head of Credit & Marketing.
- **Compliance with Credit Authorization Limits:** This is strictly ensured by the Internal Auditor in line with the Credit Policy Manual.
- **Loan Disbursement Pre-Conditions.** This is the obligatory conditions stipulated in the offer letter subject to the borrower's acceptance stated in the loan contract document:
- **Maintenance of Credit File:**The Head of Credit & Marketing ensures the safety, proper filling, pagination of all documents used for the

loan approval. Credit fully liquidated credit files are safely achieved for future management needs.

- **Micro loans Collateral Register:** All security items obtained to book approved credits are properly registered into this hard copy register for dual control purposes. They are safely maintained by the Head of Accounts & Administration.

2.1.3 Operational risk (People, Process and Technology)

Management focus on good risk management is on a larger scale of Identification, analysis, appropriate response to objectivity, consistency and avoiding blame findings by ensuring:

- Reliability of bank processes
- Reliability of technology
- Quality of personnel and value added
- Cost of doing business
- Effective risk management increases the probability of success and reduces both the probability of failure and uncertainty of not achieving the institutional set objectives.

Other Operational Risk Events

Operational risk drivers are inherent in all types of banking transactions, products, processes and systems. Operational risk is measured by evaluating all stages of operational procedures:

- **The policy of dual control**: In the Bank, the internal control system ensures and enforces dual control on captured vouchers by identifying effective *certification and authorization* of all transactions during the daily call over exercise.
  - Two authorized signatories "A" and "B" must be in all captured vouchers meant for daily call over.
  - This is to eliminate all internal frauds in operations.
- **The vault is managed under the dual control basis** with evidence of daily vault register balances. Internal control manager of the Bank ensures that the Vault Register is daily balanced and signed by the Head of Accounts & Admin manager accordingly.
- The Teller is checked by the internal control officer at the end of every business day and the Till Register is balanced and signed off by both the Internal control officer and the Head of Accounts & Admin.
- **System passwords** are given only to **authorized employees with functional responsibilities.** The computer room is restricted against unauthorized staff.
- Functional back ups are created on all tasks in the bank through job rotation policy.

- The internal control officer ensures weekly reconciliation of the correspondent banks' statement of account balances with the Bank's generated account statements. This is to support management on prompt liquidity decisions.
- Provision of account opening documentations: It is the responsibility of any officer opening any account to provide the CSO with all the required documents to fast track the relationship. Therefore, the initial amount to open the account for all incomplete documentations is passed into a dedicated suspense account awaiting full and proper documents.
- The Bank does not grant loans and advances to any account not properly documented. It is the duty of any credit processing officer to ascertain this requirement prior to the credit processing including visitation report.
- All functional tools in use in our banking operations must always be sent to the vault for overnight safe keeping.

2.1.4 Liquidity Risk

Liquidity in this context means the management and regular availability of financial resources (cash and other near-money instruments) to match any short term obligations against the bank.

- The management determines the current assets and the current liability mix which the bank should hold at all times to maintain effective liquidity.
- Daily confirmation of our correspondent banks' balances rather than the *Trial Balance* positions is used in computation of liquidity in the bank.
- Provision of weekly asserts and liability report to effectively guide management in liquidity decisions:
- Diversification of idle funds to Investments (Fixed deposit, TB, CP, Mutual Funds and Money market investments) so as to generate additional income.

2.1.5 MARKET RISK

In identifying the market risk of the bank, the balance sheet strength of the Bank is assessed regularly.

Risk on staff frauds against clients' deposits collected at the shops in the market.

- o Therefore, the Fidelity Insurance Policy is a regulatory tool in place to protect the bank.
- o SMS Alert system is in place to checkmate this inherent risk element in the Bank's operations.
- o The internal control officer calls and visits customers at random to make sure all deposit collected are remitted as at when due.

2.1.6 Compliance/Legal/Regulatory risk - This type of risk includes the following:

- Non-compliance and violation of Regulatory policies
- Unprofessional acts
- Litigations

2.1.7 Reputational risk

This refers to the trust worthiness of the Bank. It exists in the minds of both those the Bank deal directly with (i.e. stakeholders) and in the minds of those who may become aware of the bank as word of our actions circulates. The Directors and management of the Bank in making sure that all negative publicity and unprofessional acts are avoided ensures that:

- The core values of the Bank are always adhered to by all employees at all times to ensure sustenance of the bank's goodwill.
- Full regulatory compliance with all standards and guidelines.
- Maintenance of a sound customer and banker relationship supported by quality service delivery at all times.
- Top management is required to maintain high performance to guarantee the Board's continuous support and the overall sustainability of the bank. Consequently, the Board and other Management committees strive to function effectively
- Loan Recovery strategies are intelligently handled at all times.

2.2 Other Peculiar Challenges faced by the Bank

2.2.1 Weak Succession Planning: The Bank is always bedeviled with this peculiar growth problem. The rate of job turnover at all levels is very high and that makes succession planning difficult. To mitigate this challenge, management and the Board are providing the necessary support at all levels.

3. EFFECTIVE RISK MANAGEMENT

In implementing an ideal risk management system, the Bank leverages on the below four key steps:

a. Identify the risks facing the bank and assess their severity by either frequency or potential negative impacts.
b. Measure the risks appropriately and evaluate the acceptable limits for that risk
c. Monitor the risks on routine basis, ensuring that the right people receive accurate and relevant information.
d. Manage the risks through close oversight and evaluation of performance.

With the above steps, the Bank ensures that the *big picture* is not lost to the urgent demands of day to day management. It encompasses the feedback loop from the loans officer at the field to the top management and even up to the Board of Directors.

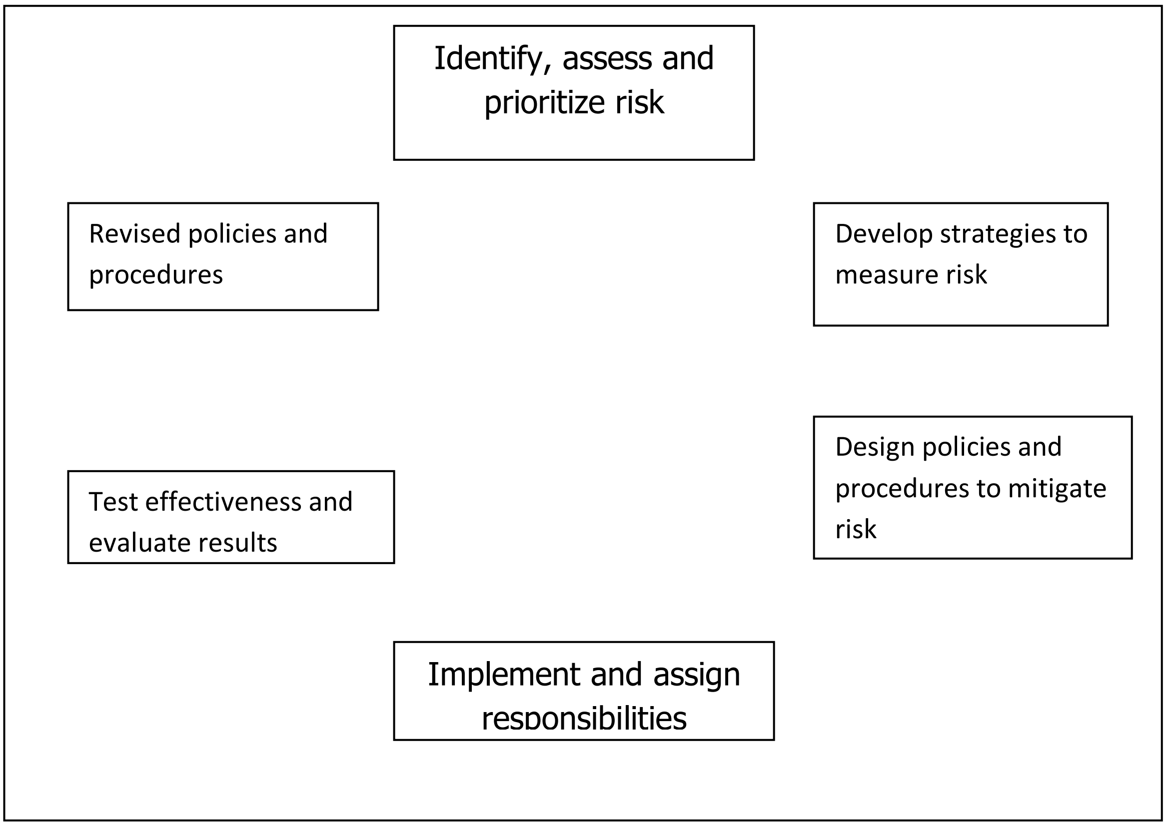
To ensure that policies and strategies are sound and the risk levels are still within the set guidelines by the bank, the following have been put in place:

- The putting together of a risk management framework to consolidate the processes into the Bank's culture which will help staff focus on identifying and anticipating the potential risks and not hiding them or denying their existence.
- Due to the fact that risk profiles vary over time, the bank places high emphases on internal discipline which is needed to review and reassess risks on a more regular basis.
- Despite being subjected to CBN regulation/supervision, the strength of the Bank's risk management is to ensure sustainable operations.

3.1 Risk Management Feedback Loop

Comprehensive Risk Management is a proactive and dynamic process. The steps are not static; they are part of an interactive and dynamic flow of information from the field to the top management and back to the field. In summary, the feedback loop includes the identification of risks to be controlled; the development and implementation of strategies and policies to control risks, and the evaluation of their effectiveness as shown in the below diagramme;

Figure 1: Risk Management Feedback Loop



If the outcome indicates that the risks are not adequately controlled, then the strategies and policies are redesigned, re- implemented, re-tested and re-evaluated. The frequency with which this process occurs depends on the priority assigned to the risk. Major risks such as credit risks, liquidity risks, etc that threatens the financial viability of the bank are generally tracked for monthly reporting to top management and the Board of Directors. Risk management ensures that management is in-tune with the actual events happening in the field and that the bank responds quickly enough to any changes in its internal or external business environment.

3.2. **Key Components**

As financial service providers, the Bank thrives on reasonable risk**.** We incorporate risk management into our organizational design, lending methodologies, savings services and operational procedures.

3.2.1 **Identify, Measure, assess and prioritize risks**

The first step the Bank takes in risk assessment is to identify risk exposures. To do this, we review our activities, function by function and ask many questions. For example, in our credit and lending operations, we examine and review the funding sources, loan transactions, portfolio processes and the returns/benefits. This approach allows management to assess the most important risks to control, the area with the weakest control and those areas where risk may be increasing.

3.2.2 **Develop Strategies to measure Identified risks**

Management develops the detailed guidelines and operational policies and procedures that fit into the broad policies. Management also recommend any changes in policies to the Board, along with rationale for each proposed change. The Board of Directors is responsible for reviewing and approving policies that minimizes risks within the strategic business plan.

3.2.3 **Design Operational Policies and Procedures to mitigate risk**

The bank lives with certain risks and design a lending methodology and system of controls and monitoring tools to ensure that risk does not exceed acceptable levels and that there is sufficient capital to absorb the loss if it occurs. These controls include:

- Policies and procedures to minimize the frequency and scale of the risk e.g. dual signatures required on loans or disbursement of savings withdrawals.
- Technology to reduce human error, speed data analysis and processing.
- MIS that provides accurate, timely and relevant data so that managers can track outputs and detect minor changes easily.

3.2.4 **Implement into Operational Procedures and Assign Responsibilities**

The bank has integrated into its operations those policies, procedures and controls to aid risk management. The Bank also assigned clear responsibilities to individual risk ownerships. To measure the effect of this implementation, management regularly seek inputs from the operational staff on the appropriateness of the selected policies, procedures and control. This is to have the necessary insight likely implications of the controls in their specific areas of operations. The designated staff is a management staff with operations experience and accountable to top management.

- By assigning this level of responsibility to the position, the bank reinforces the importance of risk management throughout the organization.

- The identifying of a risk manager with very clear responsibilities also increases the likelihood that the steps will be implemented successfully.

3.2.5 **Test Effectiveness and Evaluate Results**

Management regularly check the operating results that risk management strategies are indeed minimizing the risk as desired and this will;

- Evaluates whether the operational systems are working correctly and having the intended outcomes.
- assess whether it is managing risk in the most efficient and cost effective manner.
- Linking Internal Audit to risk management verifies the accuracy of the accounts and mitigates uncontrollable frauds and credit risks by adding client's visits into the audit processes.
- Good management reporting helps in understanding whether these controls are effective.
- Management reporting provides information on actual results compared to the budget, showing the variance and tracks down key ratios relevant to the bank's operations.
- Summary Reports for Management and Directors that capture trends in key ratios and indicators help in monitoring the overall performance and detect any changes in the financial condition or potential increased/decreased risk to the bank.
- Internal Audit Report is a critical part of the risk management feedback loop:
  - It evaluates operations "ex-post" and helps assess whether the "ex-ante" procedures and controls are effective in mitigating risk.
  - The Internal Audit processes tests the accuracy of the information coming from management reports and investigate specific areas of higher risk to the Board and management.

3.2.6 **Revise policies and procedures as necessary**

The Bank reviews and revises policies and procedures as necessary. based on the summarised reports and internal audit findings, the board reviews risk policies for necessary adjustments. This is why the Internal Audit report is sent directly to the Board. Therefore, the Board ensures that necessary revisions are quickly made to the system, policies and procedures as well as the operational workflow to mitigate potential for loss.

The internal Auditor may make recommendation on how to strengthen risk management areas depending on the audit scope. However, management is responsible for designing the specific changes, seeking inputs from the internal auditor and the staff to ensure that the operational changes are appropriate and will not result in unforeseen, negative consequences to the bank or its customers.

4. ENTERPRISE RISK MANAGEMENT FUNCTIONAL ALIGNMENT

This section of the policy defines the functional relationship of the Board, Risk Managers and Committees within the Enterprise Risk Management Program.

4.1 Defined Positions

There are many defined Risk custodians in the Bank. While their titles may change over time, it is the expectation of the Board and management that these roles will be assumed by qualified individuals during any future employee turnover or organizational changes.

4.1.1 Board of Directors has direct responsibility for the risk profile of the Bank, as defined by requirements of the shareholders. The Board assigns responsibilities to the Chief Executive Officer, who creates the infrastructure for managing risk.

4.1.2 MD/CEO oversees ERM governance, delegate's policy and day---to---day oversight to Senior Leaders and Committees, and monitors key risk indicators. The CEO utilizes the ERM structure and process to provide a global view of risks across the bank and to assess whether the aggregate risk profile has the potential to impact its viability.

4.1.3 Head Credit & Marketing Officer measures credit risk across portfolios, sets credit policy, sets and monitors key risk indicators, and is a member of the Credit Committee. This position is responsible for reviewing credit and collateral files to identify any missing or incomplete documentation, assessing the quality and collectability of loans ensuring that an independent loan review program is in place.

4.1.4 Internal Auditor serves as an independent validation of the credit risk ratings on portfolios. She/he coordinates compliance activities across the business units, tracks policy and regulatory violations. This position sets policy, coordinates the assessments, monitors and researches new and changing regulations and industry trends, updates documentation, and contributes to employee training. They leverage risk assessment information as input to annual audit planning, identify and report risk, compliance, and control issues that require resolution, monitor key risk indicators, and are the independent link to the Board through the Audit Committee.

4.1.5 Management Staff/Unit Heads represent their business units. They are responsible for understanding policies, processes, systems, products, members, and personnel within their units. Duties include participating in risk/control assessments, monitoring key risk indicators, responding to changes in industry issues, working on cross---functional projects, and implementing corrective actions and new controls.

4.2 DEFINED COMMITTEES: The Bank has 5 (Five) committees that oversees the running of the Bank.

Board of Directors – It is important to state here that all committees report directly to the Board of Directors. The Board is responsible for approving new and changes to all policies; participating in committees with managers, reviewing status; providing guidance on strategies and risk appetite; staying apprised of significant risk exposures; and ensuring that risks are managed within tolerance.

Committees
4.2.1. Board Audit & Risk Management Committee (BARMC) is a Board level Committee and is responsible for providing assistance to the Board of Directors in fulfilling their responsibility to the shareholders and investment community related to corporate accounting, reporting practices, the quality and integrity of financial reports, and the quality and effective administration of the controls and procedures of all systems and work processes. The Committee also oversees the liquidity and interest rate risk programs, shock tests, monitors key risk indicators, develops and agrees on policies and procedures, sets limits, prioritizes activities and investments, for then assets and liabilities of the bank.

4.2.2 Board Credit Committee (BCC) is chaired by a Non-Executive Director and oversees credit risk activities, assessments and stress tests, develops and agrees on policies and procedures, set limits, monitors key risk indicators and provides input to the Board regarding the direction of risks and the status of the programs.

4.2.3 Audit and Compliance Committee – This Committee oversees operations of the bank as relates to *Frauds & Forgeries,* monitors bank performance & management account quarterly, supervise external auditors and authenticate bank's financial statements as prepared by external auditors.

4.2.4 Business Development & Investor Relations Committee is in charge of the bank's Business development and recapitalisation

4.2.5 Establishment and Governance Committee is in charge of staff welfare, target & performance.

5. OBSTACLES TO EFFECTIVE RISK MANAGEMENT FRAMEWORK

The Bank understands fully the importance of risk management and is working tirelessly to make sure that it sufficiently integrate risk management systems and practice into its operations. Knowing full well that Inadequate risk management system and practices have resulted in huge loss of assets, the Bank will concentrate on carefully observing the below potholes as a means to avoid huge loss of assets:

5.1.1 Lack of Commitment- Lack of commitment towards adopting risk management policy stems largely from the absence of pressure from Directors on the management and staff to adopt risk management policy. Hence Directors of the Bank constantly reminded management and staff on the need to integrate risk management systems and practice into their operations and the importance of being committed to risk management policies.

5.1.2 Overconfidence – Management and staff will guard against becoming overconfident that with or without effective risk management the Bank can do relatively well and always have it at the back of their minds that integration of risk management systems and practice is the best way to avoid huge loss of assets.

5.1.3 Lack of capacity- The lack of sufficient capacity to perform meaningful risk management functions is a challenge to the Bank. However the all staff members have been made to understand that they are all involved in the successful integration of risk management systems and practice in the

6. CONCLUSION: In conclusion, the Bank under the supervision of the Board of Directors is dedicated to the implementation and maintenance of strategic risk management policy in the bank's operations. All qualitative results will be measured and documented with flexible reporting capabilities which will allow the Bank to measure its progress against industry accepted risk management frameworks

Approved by:

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Chairman, Board of Directors	**Chairman, Board Audit & Risk Management Committee**
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Date	Date