UNIVERSITAS INDONESIA

IMPLEMENTATION OF INTERNAL CONTROL IN MICROBANKING TO REDUCE OPERATIONAL RISKS: A CASE STUDY AT BANK XYZ

THESIS

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Submitted to fulfill one of the requirements to obtain degree of Master of Management

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STATEMENT OF ORIGINALITY

This final paper represents my own effort, any idea or excerpt from other writers in this final paper, either in form of publication or in other form of publication, if any have been acknowledge in this paper in accordance to the academic standard or reference procedures.

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IMPLEMENTATION OF INTERNAL CONTROL IN MICROBANKING TO REDUCE OPERATIONAL RISKS: A CASE STUDY AT BANK XYZ

Has successfully presented the thesis in front of Board of Examiner and is already approved as one of the requirements to achieve the title of Magister Management (MM) and Master of Business Administration (MBA) in Magister Management Study Program Faculty of Economy, Universitas Indonesia

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Date	:	16 July 2012

PREFACE

All praise and gratitude the writer turning to the presence of God Almighty for all the abundance of His blessing and grace so the writer can finish this thesis. The thesis is submitted to fulfill one of the requirements to obtain degree of Master of Management at Universitas Indonesia. The writer realizes that the results achieved so far cannot be separated from the help and support from various parties. Therefore, on this occasion the writer would like to express appreciation and gratitude as much as possible to:

1. Thomas H. Setjokusumo, MBA., my thesis counselor who patiently guide me through this final phase of the program, with his support and suggestion;
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The writer is fully aware that this thesis is far from perfect. Constructive critics, suggestions, and recommendations would cover the knowledge's constraint reflected in this thesis. Hopefully, this thesis provides benefits, especially for PT Bank XYZ, and generally for the readers.

Jakarta, 16 June 2012

Stephanie Suwandi

LETTER OF AGREEMENT TO PUBLISH THE THESIS
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ABSTRACT

Name : Stephanie Suwandi
Program Study : Master of Management – Master of Business Administration
Title : Implementation of Internal Control in Microbanking to Reduce Operational Risks: A Case Study at Bank XYZ

Every business activity is not risk-free, without exception for the banking industry. To achieve the goals set, each bank requires internal controls. But when internal control meets internal limitations, the Bank should be wise to determine what steps to take. The purpose of this study is to improve internal control in PT Bank XYZ. with regard to reduce the operational risk exposure. This thesis is a qualitative and descriptive research. Data were collected through observation and interview. Recommendations are made based on field data analysis using theoretical framework. This thesis suggests that there are several areas of internal controls that need to be improved, such as improve in preventive controls, socialization of standard operating procedures, and periodic evaluation of control itself.

Key words:
Internal control, microbanking, microlending, Micro Finance Institution (MFI)

ABSTRAK

Nama : Stephanie Suwandi
Program Studi : Magister Manajemen – *Master of Business Administration*
Judul : Penerapan Pengendalian Internal pada Bank Mikro untuk Mengurangi Risiko Operasional: Studi Kasus pada Bank XYZ.

Setiap aktivitas bisnis tidak lepas dari risiko, tak terkecuali industri perbankan. Untuk mencapai tujuan yang telah ditetapkan, setiap bank memerlukan pengendalian internal. Tetapi apabila pengendalian internal dihadapkan pada keterbatasan-keterbatasan, Bank harus bijak untuk menentukan langkah yang harus diambil. Tujuan penelitian ini adalah untuk meningkatkan pengendalian internal pada PT Bank XYZ. dengan tujuan meminimalkan risiko operasional yang dihadapi Bank. Tesis ini merupakan penelitian kualitatif dan deskriptif. Data dikumpulkan melalui proses observasi dan wawancara. Rekomendasi dibuat berdasarkan data lapangan yang dianalisis menggunakan landasan teori yang ada. Tesis ini menyarankan bahwa ada beberapa area pengendalian internal yang perlu ditingkatkan, seperti perbaikan pengendalian pencegahan, sosialisasi standar operasi prosedur, serta evaluasi pengendalian yang lebih periodik.

Kata kunci:
Pengendalian internal, bank mikro, kredit mikro, institusi pembiayaan mikro

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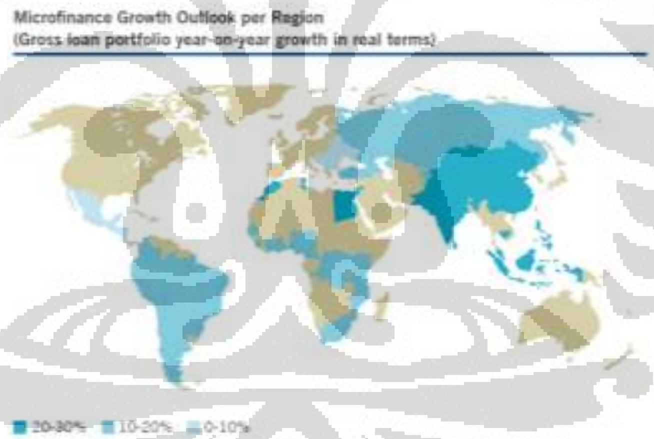
CHAPTER 1
INTRODUCTION

1.1 Background

Microfinance sector has grown rapidly for the past decades, in terms of number and size. In term of number, Microfinance Institutions (MFIs) are already numerous in some countries and serve a large number of clients. According to Consultative Group to Assist the Poor (CGAP) as cited by Hardy, Holden, and Prokopenko (2002), by 2000, MFIs worldwide served about 12.5 million individuals. While in term of size, the sector expanded with annual asset growth of 39 percent from 2004 to 2008 and accumulating total assets of over US$ 60 billion by December 2008 (Chen, Rasmussen, and Reille, 2010). A forecast predicted that this growth is going to continue in 2012 with moderate real growth rate of 15-20%, with strongest growth in South and East Asia as shown in figure below (responsAbility, 2011).



Region	Outlook 2012
Central America	5–10%
South America	10–20%
Eastern Europe	0–10%
Middle East and North Africa	15–25%
Sub-Saharan Africa	10–20%
Caucasus	10–20%
Central Asia	15–20%
South and East Asia	20–30%
Total	**15–20%**

Figure 1.1 Microfinance Growth Outlook 2012 per Region

Source: responsAbility Social Investments AG, 2011

At the same time, there are several pitfalls surrounding this impressive growth. As the businesses expand, the MFIs systems and controls are overstretched thus creating capacity gaps. Tendency to sideline procedure is likely to occur, since controls and procedures appear to be costly and slow down the speed of decision making. For instance, adding large numbers of staff in a short time without proper recruitment, training, and preparation means new staffs are not well prepared for their jobs. In other cases, a strong head office was not supported by strong middle-management level in the field operations to support the rapid growth and lack of internal controls (Chen, Rasmussen, and Reille, 2010).

Even though its business is to provide financial services to poor households and small enterprises, it doesn't mean that MFIs are immune to operating risks. Learning form experience, bank failures and widespread losses in over the past two decades was partly due to fraud and mismanagement (CGAP, 2009). Internal controls exist as a tool to manage operating risks, which to a large part are within the realm of management's direct influence and control. That is why every MFI should be aware of the importance of internal controls since ignorance of internal controls in the long run might expose an MFI to risks that can have deep and debilitating impacts on operations, resulting in higher incremental costs of poor internal control compared to anticipated initial savings (Pandey, 2010).

The implementation of internal control is not an easy matter, because there is no certain best practice for implementing internal controls. This is applied especially for MFIs, since typical MFIs branch networks are small-size and scattered, even reaches remote areas, so MFIs face barriers of high operational costs and limited human resources which there is usually only few employees in the branches. This implementation could be more complex for the new comers in the microfinance industry, such as Bank XYZ (the Bank) as systems are still evolving.

But in order to develop adequate internal control, the key point to remember is that the objective is not to eliminate risk or even to control all risks, but to determine the degree to which operational risks faced by the Bank should be controlled, and yet still able to provide reasonable assurance for the achievement of organizational objectives under effectiveness and efficiency of operations, reliability in financial reporting and compliance with applicable rules and procedures. Therefore, the Bank must develop their own internal capacities to manage and monitor risk exposures and to set up control environment that suits its business to make all components of internal control – control environment, risk assessment, control activities, information and communication, also monitoring – work well together. This thesis will evaluate the current existence of internal control systems at Bank XYZ and give feedback for future improvement, so in the long run it will contribute to sustainable profit growth.

1.2 Problem Identification

Managements of Bank XYZ have realized the importance of internal controls in their operational activities. Systems, policies, and procedures are applied in order to manage the risks faced by the Bank. In its development, as the business of the Bank grows bigger overtime, the internal control systems should be improved and aligned to the updated condition of the Bank. Next, the questions raised are whether the current internal control systems is adequate and whether it is efficient enough considering current business size of the Bank. In order to answer those questions, problem statements formulated as guidance for analysis and discussion in this paper are as followings:

a. Determine the adequacy and efficiency of Bank XYZ's internal control systems using COSO's internal control framework, by analyzing each component of internal control systems:

(1) Control environment

How does the Bank manage its environment with respect to reduce the risk exposures?

(2) Risk assessment

According to Churchill and Coster (2001), there are four general categories of risks in microfinance industry, those are institutional risks, operational risks, external risks, and financial management risks. For this research, the discussion and analysis of risk assessment and next components of internal control will be limited on operational risk. So the problem is to identify the risks regarding operational activities faced by the Bank.

(3) Control activities

How does the Bank mitigate or reduce the operational risks it faced as explained in previous questions.

(4) Information and Communication

Does information and communications technology provide relevant information for the right people at different levels of the MFI?

(5) Monitoring

What method does the Bank use to monitor the implementation of internal control in managing operational risks?

b. What are the actions that could be taken to improve the existing internal controls of the Bank to achieve sustainable growth?

1.3 Research Objectives

Based on the problem identified and the research done, the following objectives is expected to be obtained by the end of the research:

a. The adequacy of current implementation of internal control systems at Bank XYZ as micro bank to manage its operational risks, especially in microlending process, viewed from various aspects:
   (1) Control environment
   (2) Risk assessment and control activities
   (3) Information and communication
   (4) Monitoring
b. Develop recommendations that can be taken by the Bank's management to improve the existing internal control in the future to reduce operational risks exposure faced by the Bank.

1.4 Scope and Limitations

This research is limited to internal control systems for microfinance business of the Bank. Currently, Bank XYZ is giving financial services in term of microloan to individuals who run micro (very small) and small businesses or household enterprises. Some consumer loans from the previous business (before acquisition in 2010) that are still in the Bank's portfolio are excluded in the analysis and discussion as the Bank has stopped the new consumer loan and focuses only on micro loan since the acquisition. Therefore, the discussion will also be limited to Bank's performance from mid 2010 until first quarter of 2012, that is from the date the Bank was acquired by new shareholder to the latest observable timeframe.

This research will emphasize the analysis and discussion of internal control systems concentrating on Bank's operational risks, which consist of credit risk, fraud risk, and security risk. Operational risk is taken as primary consideration because the operations of an MFI present the most relevant risk and pose the greatest exposure to fraud. It is an area where MFI stands to lose the most.

1.5 Research Methodology

Methodologies used in this research are field research and literature study:

1. Field research

   Field research involves observation, structured and unstructured interview with related parties of the Bank to gain information about current practice and existing internal control systems implemented by Bank XYZ.
2. Literature study

   Relevant information for this topic are gathered from various literatures, learned, and then used as a basis for analysis.

1.6 Writing Systematic

The thesis consists of five chapters. In order to get more detailed view about the thesis, followings are outline of the chapters along with brief explanation of each chapter.

Chapter 1 Introduction

This chapter gives an overview about the current condition of microfinance business, background of the research, identified problems to be discussed, limitation and methodology of the research.

Chapter 2 Theoretical Framework

This chapter covers theories and journals that relates to problem statement expressed in the previous chapter. This literature review will be used as the main groundwork for the analysis, comprising of COSO's integrated internal control framework, microfinance risk management, and internal control in microfinance institutions.

Chapter 3 Company Profile

The chapter describes the company profile of Bank XYZ, including the Bank's vision and mission, organizational structure, microfinance business of the Bank, and its financial performance.

Chapter 4 Analysis

This chapter describes the analysis of internal control systems at Bank XYZ, specifically to manage operational risks faced by the Bank. Analysis and discussion is emphasized on special circumstances faced by the Bank as MFI that differ it from regular banking organization and control activities that needed to be taken.

Chapter 5 Conclusions and Recommendations

In this chapter, a conclusion from research analysis is drawn to answer the problems stated in Chapter 1. Suggestions for further improvements that is expected to be implemented in the Bank will also be presented in this chapter.

CHAPTER 2
THEORETICAL FRAMEWORK

2.1 Definition of Microfinance Institutions

Hardy, Holden, and Prokopenko (2002) define MFIs as financial institutions that are characterized by their commitment to assist typically poor households and small enterprises in gaining access to financial service. These financial institutions can take form in licensed and unlicensed financial institutions that include nongovernmental organizations (NGOs), commercial banks, credit unions, cooperatives, agricultural, development, and postal savings banks.

2.2 Characteristics of Microfinance Institutions

As financial institutions, both, MFIs and other commercial banks are performing similar basic functions, those are providing credit and taking deposits. Apart from the similarities, MFIs differ significantly from those of commercial banks in some way, such as client base, lending methodology and portfolio nature, administrative costs, institutional structure, and governance (Islam, 2007 as cited by Thaw, 2011). But, among those differences, the primary factors take form in two ways, the first one is MFIs' client base and the second one is MFIs' lending models.

2.2.1 Client Base

The primary clientele of MFIs is poorer households and small enterprises, defined as those who face severe barriers to access financial products from conventional financial institutions (Hardy, Holden, and Prokopenko, 2002). The common characteristics of the clients are described as followings:

- Self-employed
- Distributed in urban areas, rural areas, and sometimes remote locations
- Have little or no collateral
- Lack of credit history
- No approved financial statement

The MFIs' clients are ranging from street vendors, small farmers, service providers, to small producers. Although these typical clients are categorized as "the poor", they usually generate stable income from their activities (Ledgerwood, 1999).

2.2.2 Lending Models

In terms of lending methodology and loan portfolio, below are several characteristics of microlending that distinguish MFIs from regular banking organizations:

- Provides very small to medium-size loans, typically for working capital
- Informal appraisal of borrowers
- Significant proportion of its portfolio is unsecured

2.3 Operational Risks of Microfinance Institutions

According to risk assessment framework for MFIs proposed by Churchill and Coster (2001), which analyzes institutional development and financial health issues, the risks to microfinance institutions can be organized into four general categories:

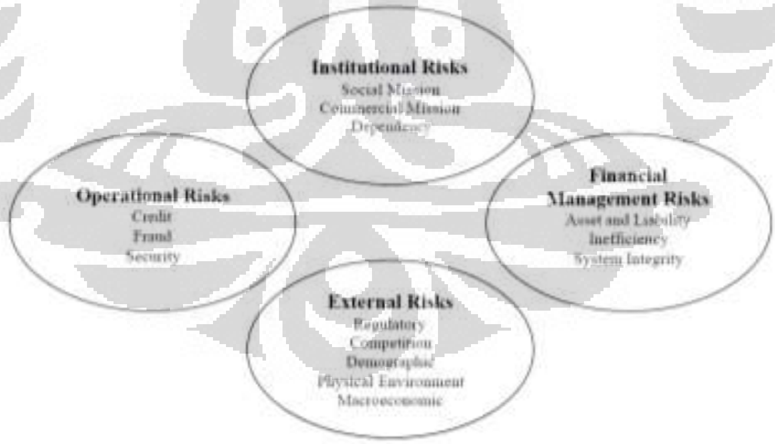


Figure 2.1 Categories of Microfinance Risks

Source: Churchill and Coster, 2001

- Institutional risks: risks that against success of MFI as an independent organization providing financial services to large numbers of low-income persons over the long term.
- Operational risks: the vulnerabilities confronting MFIs in its daily operations, including portfolio quality (credit risk), fraud risk and theft (security risk), that can result in the loss of its assets.
- Financial management risks: financial vulnerability of an MFI regarding asset and liability risks, which include interest rate, liquidity, and foreign exchange risks.
- External risks: major problems stemming from the environment in which it operates.

For the remaining discussion, microfinance risks other than operational risks will not be discussed more details, instead the research will be emphasized on operational risks as mentioned in Chapter 1. For operational risk category, Churchill and Coster (2001) divide it further into three broad categories:

2.3.1 Credit Risk

Similar to other financial institutions, the biggest risks in microfinance is loss resulting from poor portfolio quality (non-performing loan). One microloan does not pose a significant credit risk because it is such a small percentage of the total portfolio, but there are a large numbers of clients that exposed to the same risks.

There are two types of credit risk that endanger the MFI's profitability: credit default risk and concentration risk. Credit default risk is the risk of loss caused by counterpart's failure in fulfilling their obligations to repay the loans, while concentration risk is the risk associated with any single potential exposure to produce large enough losses to threaten bank's operation.

Since most microloans is unsecured, MFIs are exposed to greater credit default risk rather than other commercial banks. When clients are not able to repay, often there is no collateral can be obtained by MFI to recover the loan. This credit default risk might be wide-spread by the fact that microfinance portfolios often have a high concentration in certain business sectors (Churchill and Coster, 2001).

2.3.2 Fraud Risk

Fraud is defined as an act by which one person intends to cause wrongful gain or wrongful loss to the others. Any organization is exposed to fraud, but this exposure becomes higher for organizations that handle large volumes of money such as bank. Fraud in MFIs could take place in several activities: lending process, savings and other business operations of the branch, such as misuse of petty cash, false claims for travel reimbursement and kickbacks from procurement contracts. The vulnerabilities is multiplied if there is no clearly defined policies and procedures, if MFI has a weak management information system, high staff turnover, or if MFI experiences rapid growth.

In the lending process, there are several possible fraudulent activities which may occur in the following categories (Churchill and Coster, 2001):

- Loan disbursement, such as issuance of loans to fictive clients by loan officer, charges of unofficial fee to clients.
- Loan repayment, such as agents collecting loan payments but do not deposit them, or deposit but not in timely manner.
- Collateral procedures, such as loan officer collects collateral but does not deposit it in a storage area, or the storekeeper appropriates the collateral and conceals it by making false entries in the warehouse records
- Closure activities, such as forced savings refunds do not find their way back to the clients, and borrowers forget to ask them, loan officer collects payments on loans that have been officially written off.

An analysis made of cases brings out broadly the under mentioned four major elements responsible for the commission of fraud in banks:

- Active involvement of the staff-both supervisor and clerical either independent of external elements or in connivance with outsiders.

- Failure on the part of the bank staff to follow meticulously laid down instructions and guidelines.
- External elements perpetuating frauds on banks by forgeries or manipulations of cheques, drafts and other instruments.
- There has been a growing collusion between business, top banks executives, civil servants and politicians in power to defraud the banks, by getting the rules bent, regulations flouted and banking norms thrown to the winds.

2.3.3 Security Risk

As MFIs handle money, they are also exposed to theft, especially since MFI tends to operate in environments where crime is prevalent and temptation – due to poverty – is high.

2.4 Definition of Internal Control

Committee of Sponsoring Organizations (COSO) defines internal control as a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives (Moeller, 2007).

Process here means that internal control is a continuous tool, not an end. Internal control is not merely policy manuals and forms, but people at every level of an organization. It is expected to provide only reasonable assurance, not absolute assurance to entity's management and board and it is geared to the achievement of objectives in one or more separate but overlapping categories.

COSO's model of internal control is illustrated as a three-dimensional cube structure, with five interconnected components in one dimension, three vertical components describing organization entities and activities, and multiple objectives in the third dimension.

Figure 2.2 The COSO Internal Control Integrated Framework

Source: COSO, 1992

Internal controls is a part of risk management, given the definition of risk management as systematic approach to identifying, measuring, monitoring and managing business risks in an institution. The relationship between risk management, internal control, and internal audit can be seen in Figure 2.3.

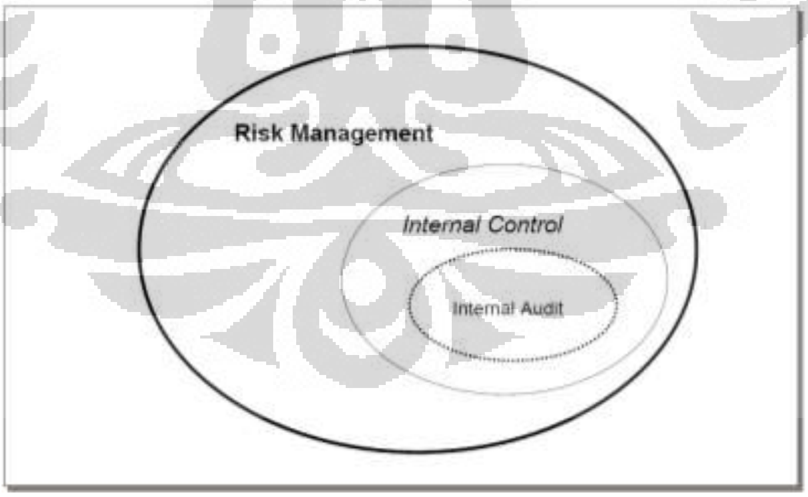


Figure 2.3 Relationship between Risk Management and Internal Control

Source: Campion, 2000

2.5 Internal Control Objectives

The purpose of effective internal control is to provide reasonable assurance for the achievement of company's objectives. In general, the objectives consist of three main categories as followings (Basel, 1998):

- Performance objectives: effectiveness and efficiency of operations
- Information objectives: reliability of financial reporting
- Compliance objectives: compliance with applicable laws and regulations

Performance objectives for internal controls pertain to the effectiveness and efficiency of the bank in using its assets and other resources and protecting the bank from loss. The internal control process seeks to ensure that personnel throughout the organization are working to achieve its goals with efficiency and integrity, without unintended or excessive cost or placing other interests (such as an employee's, vendor's or customer's interest) before those of the bank.

Information objectives address the preparation of timely, reliable, relevant reports needed for decision-making within the banking organization. They also address the need for reliable annual accounts, other financial statements and other financial-related disclosures and reports to shareholders, supervisors, and other external parties. The information received by management, the board of directors, shareholders and supervisors should be of sufficient quality and integrity that recipients can rely on the information in making decisions. The term reliable, as it relates to financial statements, refers to the preparation of statements that are presented fairly and based on comprehensive and well-defined accounting principles and rules.

Compliance objectives ensure that all banking business complies with applicable laws and regulations, supervisory requirements, and the organization's policies and procedures. This objective must be met in order to protect the bank's franchise and reputation.

2.6 Components of Internal Control

COSO identifies five interrelated components of internal control as follows:

2.6.1 Control Environment

Control environment is the base element of COSO internal control framework that keeps supporting components together. As a foundation, control environment has a pervasive influence on how business activities are structured and risks are assessed in any enterprise. It is management oversight and control culture set at the top of the organization that reflected in several ways:

- The function of the Board of Directors and the Audit Committee

  Actions of an enterprise's Board of Directors and its Audit Committee greatly influence the internal control environment of a company (Moeller, 2007). The board of directors has a responsibility to perform Good Corporate Governance (GCG) and to ensure that an adequate and effective system of internal controls is established and maintained, while the Audit Committee as the supervisory board should be truly independent from the Board of Directors.

- Management's philosophy and operating style

  The philosophy and operating style of top management may vary from extreme risk taker to super conservative, reflecting their risk appetite and business strategies, also affecting the policies and procedures settlement, enforcement, and monitoring.

  The Board of Directors should have responsibility for approving and periodically reviewing the overall business strategies and significant policies of the bank, also understanding major risks faced by bank. Toward the risks, the Board of Directors should set acceptable levels for these risks and ensure that senior managements take the necessary steps to identify, measure, monitor and control these risks. Next is the responsibility of senior managements to implement strategies and policies approved by the board, develop processes that identify, measure, monitor and control risks incurred by the bank (Basel, 1998).

  Another point is that the managements should promote high ethical and integrity standards, and establish a culture within the organization that emphasizes and demonstrates to all levels of personnel the importance of internal controls.

- Organization structure

  The managements should maintain an organizational structure that clearly assigns responsibility, authority and reporting relationships, also should do period review of the organization structure. Despite clear lines of authority, enterprises might experience inefficiencies that become greater as the enterprises expand (Moeller, 2007).

- Assignment of authority and responsibility

  The managements should ensure that there is a clear job description for each employee and ensure that this delegated responsibilities are effectively carried out (Basel, 1998). The more precise the job description can be stated and formally defined, the better. All personnel at a banking organization need to understand their role in operating process, including internal control process and to whom they should report to.

- Human resources policies and procedures

  Human resource practices cover such areas as hiring, orientation, training, evaluating, counseling, promoting, compensating, and taking appropriate remedial actions. Moeller (2007) states that a company should have strong human policies and procedures to support the messages from the top, in form of published policies in human resource areas and actual practices to send messages regarding employees' expected levels of ethical behavior and competence. The important internal control in human resource areas includes candidates' background verification, in-depth interview, new employee orientation, fair performance-evaluation program, and disciplinary actions.

2.6.2 Risk Assessment

Background for risk assessment is that an enterprise's ability to achieve its objectives can be at risk due to variety of internal and external, controllable and uncontrollable factors. Therefore, management must assess all risks facing the bank. The risk assessment should be forward-looking and performed at all levels and for virtually all activities within the enterprise.

In order to develop effective risk assessment, MFIs could follow Risk Management Feedback Loop, that is a set of process of identifying, prioritizing, and implementing risk management strategies, policies, and procedures – as illustrated in Figure 2.4.

Figure 2.4 The Risk Management Feedback Loop

Source: MEDA and MicroSave, 2007

According to Basel Committee (1998), the key principle regarding risk assessment is that internal control systems should be able to recognize material risks that could adversely affect the achievement of the bank's goals and this process has to be continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organization (such as credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks.

2.6.3 Control Activities

Control activities are the policies and procedures that help ensure that actions identified to address risks are carried out, from establishing enterprise standards with appropriate segregation of duties to reviewing, reconciling, and approving key operation reports properly. Control is not a single activity, but it is a series of activities as described in Figure 2.4, consisting of prevention (step 3 and 4), detective (step 5), and corrective (step 6) (CGAP, 2009).

- Preventive control is designed and installed to prevent undesirable outcomes before they happen.
- Detective control is designed to identify undesirable outcomes when the errors occur.
- Corrective control is designed to correct the identified error and to make sure that the undesirable outcomes do not recur.

The key to remember regarding control activities according to Basel Committee for Banking Supervision (1998) are as follows:

Principle 1 : Control activities are required to be set up as part of the daily activities of a bank and implemented throughout the entity, at all levels and in all functions. These control activities should include top level reviews, appropriate activity controls for different departments or divisions, physical controls, checking for compliance and non-compliance, approvals and authorizations systems, and verification and reconciliation system.

Principle 2 : There is appropriate segregation of duties and that personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimized, and subject to careful, independent monitoring.

There are many control activities under COSO internal controls, but they are generally include the following internal control areas:

- Adequate segregation of duties

  The key is to separate between functions of asset custody, accounting or record keeping, authorization of transactions, and operational. The person that initiates a transaction should not be the same person that authorizes the transaction.

- Top level reviews

  Boards of directors and senior management often request presentations and performance reports that enable them to review the bank's progress toward its goals.
- Activity controls

  Functional managers reviews more frequent and more detailed performance reports on a daily, weekly, or monthly basis, such as reports on delinquencies, payments received, and interest income earned on the portfolio.
- Physical controls

  Physical controls include limitation of direct access to tangible assets, including cash and securities, dual custody, and periodic inventories.
- Compliance with exposure limits

  It is started with the establishment of clear limits, especially for borrowers and complemented with process of reviewing compliance towards such limits.
- Proper authorization of transactions and activities

  Certain limits requires awareness from certain level of management regarding transaction or situation, thus requires appropriate approval and authorization for accountability.
- Verifications and reconciliations

  Control activities include verifying transaction details and reports, such as comparing cash flows to account records and statements, also checking arithmetical accuracy, comparing budget and realization, reviewing standard performance, and preparing exception reports.
- Adequate documents and records

  Processes should be appropriately documented.

Related to this research regarding operational risks in MFIs, Churchill and Coster (2001) expressed some controls activities that can be done to manage credit risks, fraud risks, and security risks.

a. Credit Risk Controls

Control activities to manage credit risk consist of credit risk prevention, credit risk detection, and credit risk collection, meaning the controls exist before the loan application and loan disbursement, during the loan repayment terms until the loan agreement is over.

Loan risk prevention includes loan product designs, client screening, set up Credit Committee, and loan portfolio diversification.

- Loan Product Designs

  Reducing credit risk can be done through product design features which include eligibility, amount and terms of the loan, along with the repayment frequencies, collateral requirements, interest rates and fees.
- Client Screening

  Limiting credit risk also involves screening client carefully, by analyzing each components of client (Table 2.1).

Table 2.1 The Five C's of Client Screening

Character	An indication of the applicant's willingness to repay and ability to run the enterprise.
Capacity	Whether the cash flow of the business (or household) can service loan repayments.
Capital	Assets and liabilities of the business and/or household.
Collateral	Access to an asset that the applicant is willing to cede in case of non-payment, or a guarantee by a respected person to repay a loan in default.
Conditions	A business plan that considers the level of competition and the market for the product or service, and the legal and economic environment.

Source: Churchill and Coster, 2001

- Credit Committee

  A credit committee consisting of two or more persons to make decisions regarding loans and written policies regarding loan approval authority are required to reduce the abuse of power and to reduce risks of loans being inappropriately approved.

- Portfolio Diversification

  MFI need to diversify its portfolio into diverse geographic sector, market segment and industries.

In order to monitor portfolio quality, credit risk detection need to be done by monitoring portfolio quality ratio once a month at a minimum and by maintaining an aging schedule. But, when the arrears or late payments occur, or even the credit defaults, actions dealing with arrears or defaults should be encouraged. Some common corrective controls of credit default risk are rescheduling, reconditioning, and restructuring.

b. Fraud Risk Controls

Control activities to manage fraud risks should be done through preventive controls, detective controls, and also corrective controls to improve the internal control procedures and to avoid the recurrence of errors in the future. Several prevention controls to reduce fraud are maintaining excellent portfolio quality, simplicity and transparency, human resources policies, client education, credit committees, handling cash, handling collateral, and write-off and rescheduling policies (Churchill and Coster, 2001).

Even the best preventive controls can't eliminate fraud, that is why detective controls of fraud detective is required. Fraud detection involves operational audit, loan collection policies, client sampling, and customer complaints (Churchill and Coster, 2001).

- Operational audit is conducted to ensure that policies within the organization is followed. A violation toward policies might be a signal that the employee was involved in some sort of fraudulent activity.
- Loan collection policies should require to involve several different persons in the collection process in order to reduce the possible fraud risk of pocketing repayments.

- The most effective way to discover fraud in lending process is by conducting client visits. In MFIs, among the large volumes of customers, client sampling is used in order to select several borrowers for balance confirmation and client visits.
- MFI should provide proper communication channel to facilitate any customer complaints.

If fraud is suspected, MFI could conduct a fraud audit and then after the fraud is identified, the management should take necessary action toward the perpetrator according to human resources policies regarding reward and punishment.

c. Security Risk Controls

Control activities to manage security risk involves two aspects, safety of cash and safety of office assets.

- Reducing risk of theft of cash can be done through conducting Bank's financial transactions through bank account.
- Reducing risk of theft of office assets can be done through maintaining fixed asset registry and do periodic asset opname.

2.6.4 Information and Communication

COSO internal control framework also emphasize on the importance of information and communication. Both components are related to each other, but they are really distinct internal control components. Information are needed at all levels of the organization to achieve operational, financial reporting, and compliance objectives, so here the importance of information system is to identify, capture, and communicate relevant information that consistent with overall organization needs. While communications are channels that provide the details to individuals to carry out their financial reporting, operational, and compliance responsibilities, that must flow in two directions across the organization and also to interested outside parties in order to be effective.

Appropriate information, supported by automated or manual systems, must be communicated up and down in a manner and time frame that allow people to carry out their responsibilities. Effective information system also should be able to adapt to support change on many levels.

According to Basel Committee (1998), the key principles regarding information and communication are:

Principle 1 : An effective internal control system requires that there are adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely, accessible, and provided in a consistent format.

Principle 2 : An effective internal control system requires that there are reliable information systems in place that cover all significant activities of the bank. These systems, including those that hold and use data in an electronic form, must be secure, monitored independently and supported by adequate contingency arrangements.

Principle 3 : An effective internal control system requires effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and that other relevant information is reaching the appropriate personnel.

Typically, microfinance has two main systems: the accounting system and the portfolio tracking system. The accounting system handles the financial management, centered on the chart of accounts and general ledger, while the portfolio management system is used to track the performance of each financial product offered by the institution, such as credit products and saving products. The relationship between accounting system and portfolio tracking system is shown in Figure 2.5.

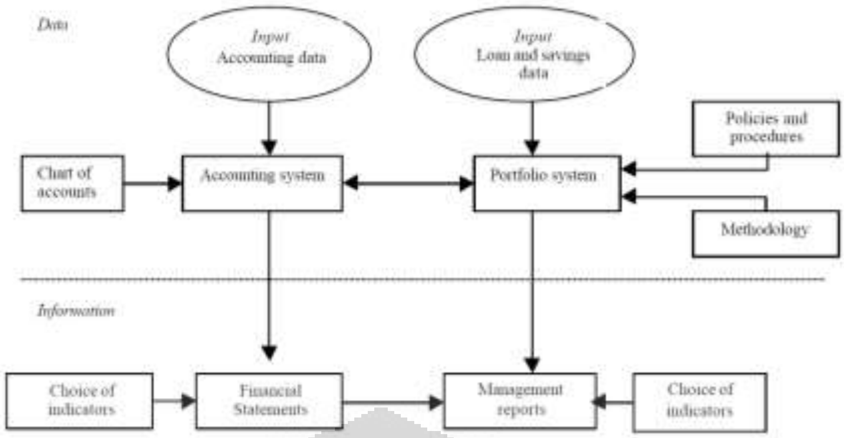


Figure 2.5 Part of Management Information System

Source: Churchill and Coster, 2011

2.6.5 Monitoring

Monitoring is the capstone of the internal control. Since the control procedures and other systems changed over time, internal control should be monitored to assess the effectiveness of established internal control components and to take corrective action when appropriate.

There are two types of monitoring activities:

- Ongoing monitoring activities
  It is activity that reviews enterprise activities on a regular basis and then suggests potential corrective actions.
- Separate internal control evaluation
  It is an evaluation for which the scope and frequency will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures.

According to Basel Committee (1998), the key principles regarding monitoring are:

Principle 1 : The overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the bank as well as periodic evaluations by the business lines and internal audit.

Principle 2 : There should be an effective and comprehensive internal audit of the internal control system carried out by operationally independent, appropriately trained and competent staff. The internal audit function, as part of the monitoring of the system of internal controls, should report directly to the board of directors or its audit committee, and to senior management.

Principle 3 : Internal control deficiencies, whether identified by business line, internal audit, or other control personnel, should be reported in a timely manner to the appropriate management level and addressed promptly. Material internal control deficiencies should be reported to senior management and the board of directors.

2.7 Internal Control Evaluation

As mentioned before, one component of internal control systems is monitoring. To make sure the effectiveness and efficiency of internal control, internal control should be evaluated. The evaluation involves:

a. Identifying the internal control objectives relevant to the bank, department, business line, or product;
b. Reviewing pertinent policies, procedures, and documentation;
c. Discussing controls with appropriate levels of bank personnel;
d. Observing the control environment;
e. Testing transactions as appropriate;
f. Sharing findings, concerns, and recommendations with the board of directors and senior management;
g. Determining that the bank has taken timely corrective action on noted deficiencies.

In evaluating the internal control, several things in relation to the bank should be considered, such as asset size, organization and ownership characteristics, business activities, operational complexity, risk profile, methods of processing data, legal and regulatory requirements.

CHAPTER 3
COMPANY PROFILE

3.1 Overview of Bank XYZ

PT XYZ (“Bank XYZ” or “the Bank”) was launched in second semester of 2010. This bank was actually not a new comer in the banking industry, but due to financial difficulties, the Bank was advised to get additional capital. After several meeting and negotiations, the General Meeting of Shareholders agreed to the entry of a new shareholder that also acts as the new controlling entity of the Bank.

The entrance of new investor brought significant changes to the Bank. Along with the identity change, Bank XYZ changed its business strategy, which previously focused on corporate sector and consumer loan, now focuses on micro financing with target market of Micro and Small and Medium Enterprises. In order to be in lined with the new financing focus, Bank XYZ also changed the funding focus to retail funding.

Under the new management, Bank XYZ shows a good improvement, in terms of financial performance and business expansion. In financial terms, Capital Adequacy Ratio (CAR) of the Bank increase by 50.40% and Non Performing Loan (NPL) ratio decrease from 21.15% on March 30, 2010 to 4.14% as of July 31, 2010. While in business practices, Bank XYZ has 168 branches by the end of 2011 that spread over 44 cities in Indonesia, employ more than 5.500 workers, and accumulate total assets of more than 4.5 trillion Rupiahs. The growth continues on 2012 so by the end of March 31, 2012, Bank XYZ already has 181 branches, employ more than 6.300 workers, and accumulate total assets of approximately 6.3 trillion Rupiahs.

3.2 Vision, Mission, and Values

The Bank’s vision is to achieve bright future through synergistic partnerships that bridge the diversity and dynamics of Indonesia society, while its mission is to be a leading retail bank and trusted partner for the Indonesian people through:

a. Partnership
  - Establishes sustainable partnerships based on sincere caring, dedication and passion for growth.
  - Promotes synergy with orientation toward affordability, convenience and growth to become preferred bank for micro, small and medium enterprises (SMEs), and also individuals.

b. Diversity
  - Provides a wide selection of financial products and services that meet the dynamic and various needs of society.
  - Develops competence and excellent infrastructure that support the continuous and affordable services to customers.

c. Prosperity
  - Sharpen the Bank's potentials and enforces life-quality improvement of individuals that are oriented to prosperity.
  - Promotes prosperity by building a foundation that supports the welfare of micro enterprises, SMEs and also the Indonesian people as individuals.

In carrying out the vision and mission, managements of Bank XYZ also set several core values that used as the Bank's fundamentals in its daily operating activities. Those values are:

- Reachable – accessible, comfortable, and practical
- Progressive – customer-focused, innovative, and progress-oriented
- Professional – integrity, sincere concern, expertise and excellence

3.3 Strategy and Business Model

In accordance with the Bank's mission to position itself as partners for Micro, Small and Medium Enterprises (SMEs), strategy of Bank XYZ is to focus on microlending. New micro financing was commenced on third quarter of 2010, while for the existing consumer loans are only focused on collection and not be extended. In order to secure its micro financing business, Bank XYZ committed to build up retail funding. Focusing on deposits from retail customers, the Bank offers 3 types of products: demand deposits, savings deposits, and time deposits. To attract and grab the market attention, the Bank offers higher interest rate than the market rate and offers special gift for placement with certain minimum amount and certain minimum holding period of time.

Bank XYZ offers its products and services through its distributed network of branches that are organized based on its geography location. Overall, the Bank's operation nationwide is divided into 8 Regions, consisting of 2 regions in Sumatera, 4 regions in Java, 1 region that covers Bali and Sumbawa, and 1 region that covers Kalimantan, Sulawesi, Maluku and Papua. Each regions is divided into several Areas, where each Area consists of several branches that led by one Main Branch Office.

There are two types of branches, regular branch and ladies branch. Regular branches or sub-branches handle lending and funding operations, while ladies branches only handle funding operations. Both lending and funding operations are adequately decentralized and branches are treated as profit centers, except for Ladies Branches. While other product or service, like transactions via Automatic Teller Machines are centrally maintained in the Head Office.

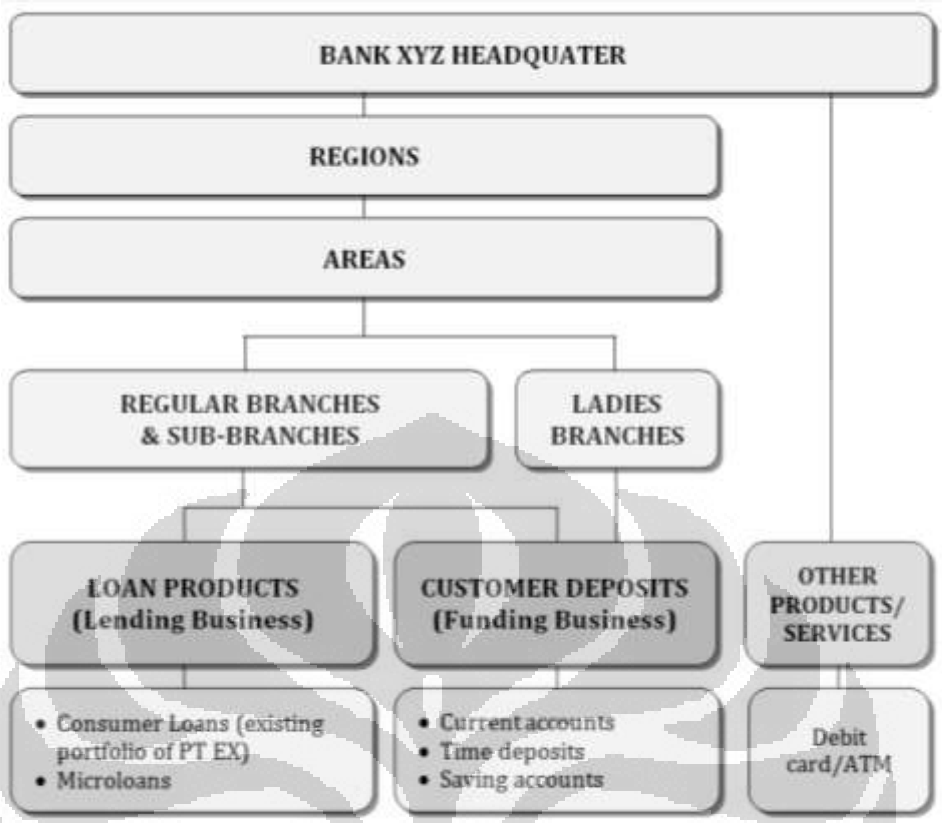


Figure 3.1 Branch Networking and Business of Bank XYZ

Source: Business Development Division of Bank XYZ

3.4 Organization Structure

Under current organizational structure, departmentalization in Bank XYZ is developed based on functions performed, where employees within certain division are doing similar and specialized task. Some of those divisions are Compliance, Risk Management, Human Capital, Operation, Information and Technology, General Affair, Legal, Credit Policy and Support, Business Development, Finance, and Corporate Planning and Budget Control (detailed functional departments can be seen in Figure 3.2). In each division, there is a Division Head who responsible to control the performance of the division and then report periodically to the Board of Directors.

Given delegation to run the Bank by the General Meeting of Shareholders, the Board of Directors is supervised by the Board of Commissioners in doing their responsibility and authority. Under the Board of Commissioners, there are three committees that are independent from the Board of Directors. They are Risk

Oversight Committee, Remuneration and Nomination Committee, and Audit Committee. While for supervision in the lower level, there is Internal Audit Division who should report to the Board of Directors, as well as to the Board of Commissioners, specifically Audit Committee.

While the organizational structure in the Headquarter is specialized based on functionality, the organizational structure in the Regional area is specialized based on products offered – lending and funding – as illustrated in Figure 3.3 and Figure 3.4. The organization structure in Regional, Area, and its sub-branches promotes dual reporting line, first, bureaucracy line according to the branch office hierarchy and second, responsibility line to the respective functional division in the Head Office.

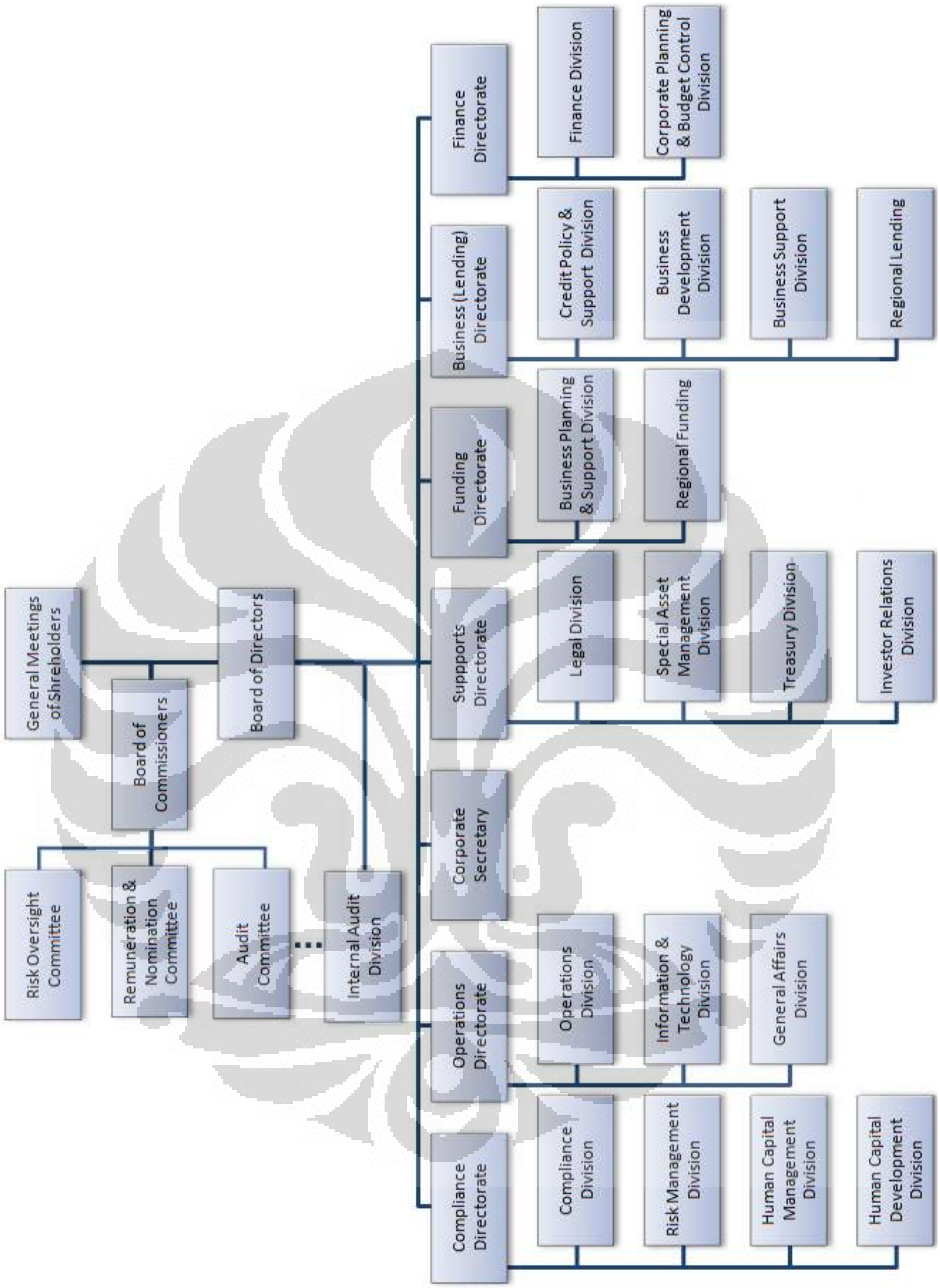


Figure 3.2 Organization Structure at Bank XYZ

Source: Human Capital Management Division of Bank XYZ

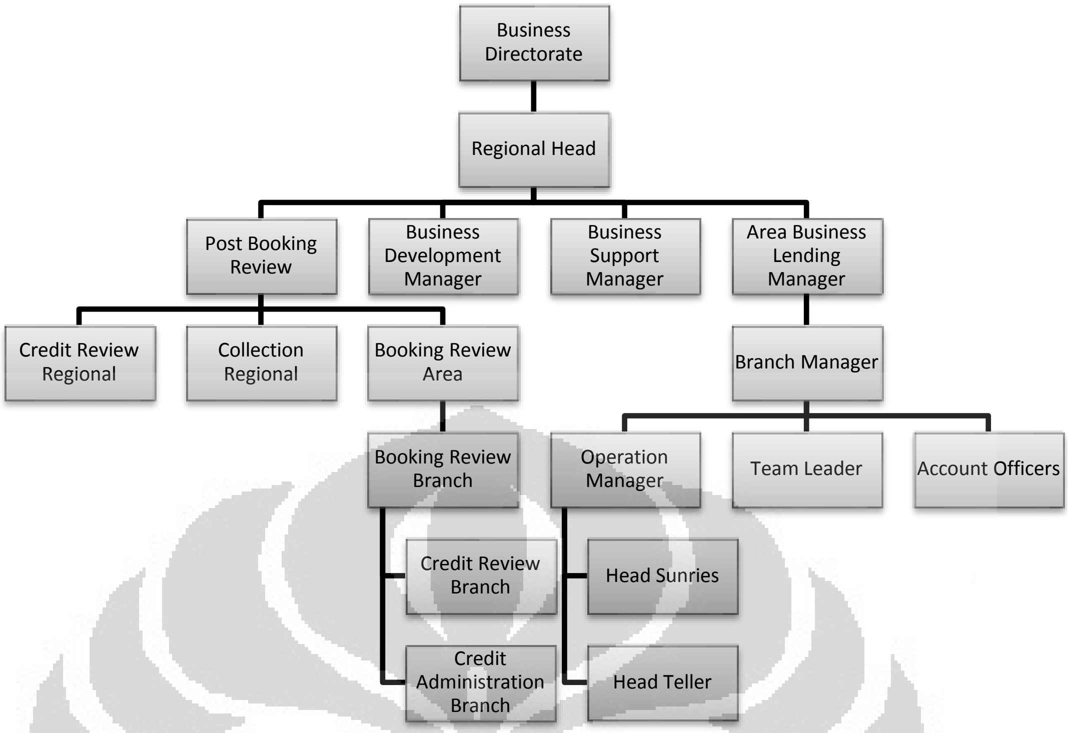


Figure 3.3 Organization Structure for Lending Business at Branch

Source: Human Capital Management Division of Bank XYZ

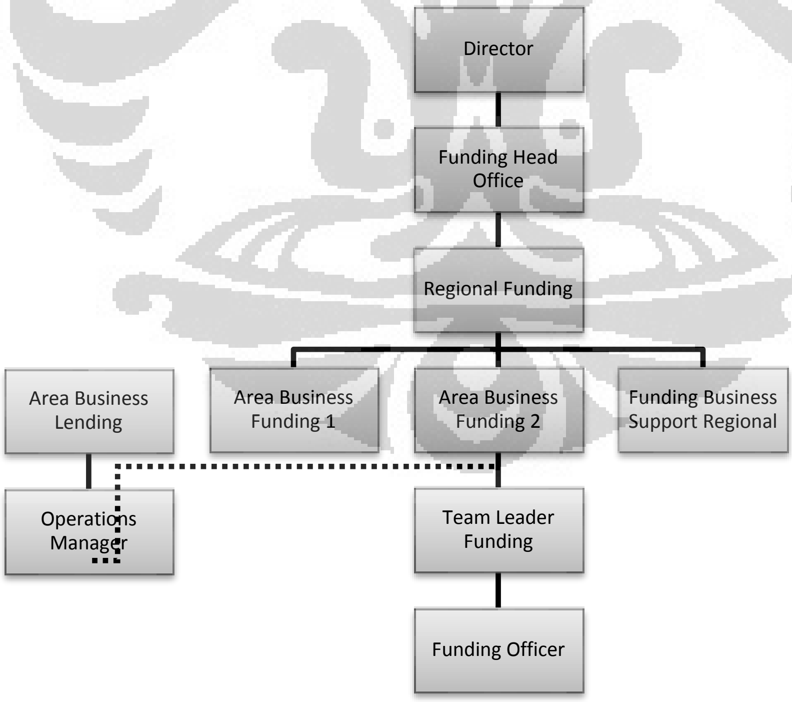


Figure 3.4 Organization Structure for Funding Business at Branch

Source: Human Capital Management Division of Bank XYZ

3.5 Financial Performance

The entrance of the new investors in the mid of 2010 has brought good impact to the Bank's performances. From 2010 to 2011, total assets of the Bank increases significantly. Loans and customers' deposits portfolio also grow more than 300%, showing that people have trusted Bank XYZ better.

In terms of income and expenses, by the end of 2011, the Bank still recorded loss, instead of gain. The loss suffered by the Bank was mainly caused by huge operating expenses incurred in order to expand its branch networks, resulting in the opening of 187 offices by December 2011. Later on, from January to March 2012, the Bank has been able to record profitable growth.

3.6 Microfinance Business of Bank XYZ

After gone through several fundamental changes – change in controlling entity, change in term of Bank's brand, change in business focus – in the mid 2010, the Bank was ready to step on to develop its new business as a commercial bank which is specialized in microlending and retail funding.

To manage the change of business focus, the realization of previous loan products was stopped for few months and thus by the end of 2010, the Bank launched new types of loans as followings:

a. Investment loan for micro business "AA"

Loan purpose	: for investment
Loan amount	: 4,500,000 up to 45,000,000 Rupiahs
Loan terms	: 6 to 36 months
Collateral	: not required

b. Investment loan for micro business "AB"

Loan purpose	: for investment
Loan amount	: 4,500,000 up to 45,000,000 Rupiahs
Loan terms	: 12 to 60 months
Collateral	: required (land/housing, vehicle, or time deposits)

c. Investment loan for micro business "AC"

Loan purpose : for investment

Loan amount : 46,000,000 up to 180,000,000 Rupiahs

Loan terms : 12 to 60 months

Collateral : required (land/housing, vehicle, or time deposits)

d. Investment loan for micro business "AD"

Loan purpose : for investment

Loan amount : 181,000,000 up to 450,000,000 Rupiahs

Loan terms : 12 to 60 months

Collateral : required (land/housing, vehicle, or time deposits)

e. Working capital loan for micro business "BA"

Loan purpose : for working capital

Loan amount : 4,500,000 up to 45,000,000 Rupiahs

Loan terms : 6 to 36 months

Collateral : not required

f. Working capital loan for micro business "BB"

Loan purpose : for working capital

Loan amount : 4,500,000 up to 45,000,000 Rupiahs

Loan terms : 6 to 36 months

Collateral : required (land/housing, vehicle, or time deposits)

g. Working capital loan for micro business "BC"

Loan purpose : for working capital

Loan amount : 46,000,000 up to 180,000,000 Rupiahs

Loan terms : 6 to 36 months

Collateral : required (land/housing, vehicle, or time deposits)

h. Working capital loan for micro business "BD"

Loan purpose : for working capital

Loan amount : 181,000,000 up to 450,000,000 Rupiahs

Loan terms : 6 to 36 months

Collateral : required (land/housing, vehicle, or time deposits)

Management of the Bank is very concern about microlending business development. It is proven through out of approximately 5,500 employees of the Bank, more than 50% are assigned to credit process, as Account Officer, Team Leader, and Area Business Lending Manager.

At first, the credit process of Bank XYZ was centralized in the Head Office. Later on, as the business of the Bank expands, the management encourages the decentralization of loan approval decision to Regional, Area, and Branch Level.

Below are several employees involved in the credit process and brief description of each job description:

- Account Officer (AO).

  AO acts as the link between the clients and the institutions. AO is responsible for initial contact with client and maintain good relationship with client.
- Credit Committee

  It is a committee formed in each branch/level who held responsibility for approving loans within their limit.
- Team Leader

  A Team Leader is the one who leads and educate a group consisting of several account officers. Besides, Team Leader also has to review the loan applications.
- Branch Manager/Area Business Lending Manager/Regional Head

  Branch Manager/Area Business Lending Manager/Regional Head supervises the performance of account officer, credit administrator, and portfolio of the Branch/Area/Region respectively.
- Credit Review

  Credit review is the one who has to evaluate the creditworthiness of a client and give input for the loan approval decision.
- Booking Review

  Booking Review controls and monitors the loan-related journal entries.

- Credit Administrator

  Credit Administrator is the one who responsible to maintain the documentation of a loan portfolio.

There are several main activities in microlending, starting from loan approval and loan disbursement, loan repayment, loan provisioning and write-off.

3.6.1 Loan Approval and Loan Disbursement

Once a customer applies for loan to the Bank, his/her business is first analyzed by the account officer who suggests loan's conditions. The account officer conducts preliminary appraisal of the potential client. After the account officer is sure about a client's business and his/her creditworthiness, then the loan application was proposed to the Credit Committee.

Members of Credit Committees in Bank XYZ at each level of approval along with their approval limit of Credit Committee are disclosed in table 3.2.

Table 3.1 Composition of Credit Committee at Each Branch Level

Branch Level	Members of Credit Committee	Maximum Limit of Loan Approval
Sub-branches	– Branch Manager – Team Leader – Booking Review – Credit Review	90,000,000 Rupiahs
Area/main-branches	– Area Business Lending Manager – Team Leader – Area Booking Review – Area Credit Review	225,000,000 Rupiahs
Regional	– Regional Head – Post Booking Review – Credit Review Regional	450,000,000 Rupiahs

Source: Credit Policy and Support Division of Bank XYZ

Credit Committee then, will review the loan application and make loan decision/approval. Any loan application that exceeds the approval limit should be asked for one-up level approval. For approved application, Credit Review prepares Loan Approval Memorandum. Next, the memorandum is forwarded to Booking Review in order to check whether the loan disbursement has complied with the Bank's procedures and policies based on the documentation attached.

From Booking Review, the loan documentations is passed to Credit Administration for insurance registration and loan facility entry in the Bank's core banking system. The loan disbursement itself is done by Operation Officer, and the loan documents will be returned to the Credit Administration to be filed.

3.6.2 Loan Repayment

The loan repayment for performing loan should be done through each client's account in Bank XYZ. Account Officer can only collects repayment of non-performing loan. Every repayment made by the client, they will get the repayment receipt.

3.6.3 Loan Provisioning and Write-Off

While the loan approval has been decentralized, the loan provisioning and write-off decision is still highly centralized. Since there is new accounting standard regarding the loan provisioning that involves risk-modeling of Bankwide, the loan provisioning is maintained in the Head Office with the help of special system to do the computation. Here, the branches' contribution is to give future cash flow estimation of the loans. While for each write-off proposal, it should be asked for Headquater's approval.

CHAPTER 4
ANALYSIS

4.1 Control Environment

Control environment plays a vital role in the organization's internal control systems, as it provides foundation for the other components of internal control. In microfinance industry, the role becomes much more important since MFIs operate in environment with high tolerance for fraud, especially in Indonesia, a country with high corruption rate. Therefore, Bank XYZ should be carefully sets its control environment.

In order to assess the adequacy of current control environment of the Bank, we will evaluate the elements of the control environment one by one as followings:

4.1.1 The Function of the Board of Directors and the Audit Committee

As described in Figure 3.2, the Board of Directors is supervised by the Audit Committee in doing their responsibilities and authorities. The position of the Audit Committee in the organization structure is under the Board of Commissioners, so the Audit Committee is an independent committee outside of the Board of Directors. Several criterions to prove the competence and independency of the Audit Committee has been fulfilled, such as:

- Every member of Audit Committee has a good qualification in banking industry or auditing experience.
- None of the members are ex-director of Bank XYZ or other banks.
- Members of Audit Committee do not have special relationships with the shareholders or the Board of Directors of the Bank that can affect its independency.

The responsibilities of the Audit Committee are:

- Monitors and evaluates policies and implementation of internal audit.
- Reviews Audit Report, Annual Audit Plan, selected Public Accounting Firm, and other internal provisions.

- Gives recommendations to the Board of Commissioners regarding operational of the Bank.
- Conducts periodic meetings to evaluates performance and strategic business plan of the Bank.

So far, Audit Committee has performed good in carrying out their responsibilities. They have given reports, feedbacks and recommendations to the Board of Commissioners about operational activities of the Bank which required Directors' attention, including audit result, socialization of standard operating procedures, and change in organizational structure. They also have done periodic meetings which are attended by all Audit Committees.

In conducting all activities in the Bank, the Board of Commissioners and the Board of Directors always promote GCG, through maintaining business ethics, fairness and equity, and transparency, as presented in the Bank's core values. The result is that GCG self assessment shows a "good" mark in 2011, better than "adequate" in 2010.

4.1.2 Management's Philosophy and Operating Style

Management's philosophy toward risks is reflected in the policies and procedures of the Bank. Having high vulnerability of credit risk doesn't push the management to apply strict policy such as "zero tolerance for arrears", because they believe that retail clients are still able to repay their loans although in longer period of time, as long as they have good character and intention. Vice versa, management of Bank XYZ also doesn't allow loan disbursement without proper creditworthiness assessment. Therefore, policies and procedures in the Bank allow remedial action for non-performing loan such as loan rescheduling yet still require several control tools such as existence of Credit Committee, client screening, level of approval, segregation of duties to provide reasonable assurance to maintain non-performing loan (NPL) ratio at maximum of 5%, in lined with the Central Bank's regulations.

The vision, mission, values, and policies and procedures are set by the management as guidance of operating activities to ensure that all activities are done toward the same goal, through the same principles, although the existing policies and procedures have not covered all aspects of the Bank's operational activities. The enforcement of vision, mission, values, policies, and procedures at Bank XYZ is done through top-down approach. Due to high fraud vulnerability in MFI exposed from the employee, the top-down approach will be more effective if it is done in more persuasive way. Based on interview and observation done, the top down approach at Bank XYZ to enforce vision, mission, values, policies and procedures is done through trainings, meetings, incentives, and tone at the top. The management of the Bank periodically visits the branches to build the employee's consciousness toward achievement of company goal, increase employee's sense of belonging toward the company, through personal relationship

Overall, the management's philosophy and operating style at Bank XYZ are designed properly and implemented consistently, but as the Bank experienced massive expansion, the management should pay more attention to the development and improvement of current policies and procedures since this area is a little bit left behind.

4.1.3 Organizational Structure

The organization structure of Bank XYZ as described in Figure 3.2 was effective on August 2011. This type of organization structure is combination of functional, product divisional and matrix organization structure. It is functional at the top of the structure, but goes to regional and lower level of hierarchy the structure adapts the product divisional, funding and lending. The design is intended to achieve the Bank's mission to be a leading retail bank and a trusted partner. In order to improve understanding about customers and to provide better services, the management of the Bank deal to do it in specialized way, thus the Bank's activities is divided into two main product streams, funding and lending. The other supporting divisions are shared among those two product divisions to promote efficiency.

Furthermore in Regions, Areas, or Branches, the matrix structure exists to promote coordination, since it enables dual reporting line. In branches, the first reporting line of officers goes to Branch Manager under Operations Director to improve the daily operating activities of the branches. The second reporting goes to related Business Head, either Funding Group Head or Lending Group Head (also known as Business Group Head) in order to improve controls and monitoring towards products.

In the implementation, the management of Bank XYZ periodically reviews the organization structure. In initial period after acquisition, there were only three members of the Board of Directors. Later on, in the mid 2011, as the business of the Bank grows, the existing organization structure is considered not appropriate any longer with the expanding capacity, and thus it is revised to current organization structure – consisting of five members of the Board of Directors – that applicable until now.

4.1.4 Assignment of Authority and Responsibility

Assignment of each employee's authority is clearly seen in the organization structure. While assignment of responsibility is created through input from each functional divisions and then, established formally through job description by Human Capital Management Division. At first, there was no clear job description for each job and position, but as the Bank continues to improve itself, now there are job descriptions which state clearly one's responsibility and authority. Each personnel is given a copy of this job description, so they can learn and understand their roles, authorities, and responsibilities.

For implementation and monitoring, Division Head is the one who is held accountable to ensure that delegated responsibilities are effectively carried out in their divisions and give feedback if there is any modification needed. Moreover, temporarily structure is also created for certain projects to assign clear responsibility, authority, and reporting relationship within the project teams.

4.1.5 Human Resources Policies and Procedures

In microfinance industry, the key success of sustainable growth depends heavily on its human resources, especially account officers since maintaining customers, from loan application to loan repayment become the responsibility of the account officers. Therefore, human resources policies is important especially to screen employees' character to reduce fraud risks.

At Bank XYZ, there are published policies regarding human resource practices that cover areas of recruitment and hiring, training, evaluating, and promoting. In recruitment and hiring area, the Banks has published policies for job's requirements and necessity to conduct interview. But as the demand of workers is pretty high, many among those new employees are not undergo new employee orientation, they just got into the work and they'll be trained later on. While in training area, there are policies and procedures to follow training or even to conduct training, but there is no policies regarding the training requirements for each job/position. Human Resources Management Division of Bank XYZ also has certain standards for employees' evaluation and promotion. Key performance indicators are determined for each job that also can be beneficial to control employees' behavior. Unfortunately, there hasn't any policies regarding counseling and appropriate remedial actions.

In the real world, the implementation of human resources management is still initiated and highly centralized in the headquarters, such as for compensation and promotion. Human resources in Region areas exist to help the Human Resources Division in the Headquarters in monitoring the policies and procedures that have approved and published.

Policies and procedures regarding human resources should be more detailed in order to create a conducive environment that can reduce credit and fraud risk.

4.2 Risk Assessment and Control Activities

As mentioned in the research limitation in the Chapter 1, the discussion and analysis will be emphasized on operational risks, since daily operating activities of the MFIs involves huge volume transactions and cash management. In order to improve the internal control systems of Bank XYZ, the Bank continually assess the possible risks that might occur in the Bank's operating activities. These possible risks can be divided into 3 broad categories of operational risks: credit risk, fraud risk, and security risk.

4.2.1 Credit Risk and Control Procedures

Even though the nature of the Bank's loan portfolio is different from other commercial banks, both of them are exposed to credit risk. What differs Bank XYZ as MFI compared to other commercial banks is that Bank XYZ suffers greater exposure of credit default. The main cause is the clients' characters. As known from Chapter 3, target markets of Bank XYZ are individuals who run micro and small business or household enterprises, and this market segment consists of middle and lower class of society, who usually don't have sufficient formal collateral to back-up their loans. Besides, it is harder to assess the creditworthiness of the applicants since they didn't have formal financial reports which the Bank can rely on to judge their business performance or in case the financial report exists, the Bank is faced to risks regarding the accuracy and reliability of the report.

The impact of credit risk to the Bank is that the Bank won't be able to get back its money, while sometimes the collateral is not sufficient to cover the outstanding principal of the loan. Individually the loss suffered by the Bank from one credit default is not significant considering the nature of the loan which is very small to medium-size loan, but collectively, the Bank has numerous loan facilities and if these loan facilities are not managed carefully and become default, it could harm the Bank's performance. Furthermore, the increasing amount of default loans will increase the Bank's NPL ratio and decrease capital adequacy ratio (CAR) – two of key performance indicators in banking organization. When NPL exceeds amount of 5%, the maximum limit allowed by the Central Bank, the Bank will be classified as "under intensive supervision of the Central Bank", thus brings negative impact to the Bank's image. The case will be worse when CAR decreases until below than minimum limit of 8%, the Bank will pushed by the Central Bank to stop the loan disbursement.

Considering the possible impacts of credit risks to the Bank, it is important to design policies and procedures in order to mitigate the risks.

a. Preventive Control

Controls to reduce credit risks should be done starting from processing of loan applications and loan disbursements. This first layer of controls can be achieved through several ways: loan product designs, client screening, credit committees.

Controlling credit risk through loan product designs means featuring loan products that meet client needs and capable to address specific purpose for which the loan is intended. Bank XYZ has designed its loan products to fit the Bank's risk appetite.

Table 4.1 Loan Product Designs at Bank XYZ

Product Design Features	Control Activities
Eligibility Requirements	Loan is eligible for individual person who runs micro and small business and he/she is required to have been in similar business for at least 2 years. The loan is given for working capital or investment loan, not consumption loan.
Loan Amounts	There are different limits of loan amount that can be granted in each approval authority (refer to table 3.2). For greater amount of loan that exceeded branch's limit, it should been asked for one-up level approval.
Loan Terms	The loan terms can be varied within certain range of repayment period and it has been regulated in the Bank's credit policies. This credit policies is communicated to all branches to be implemented equally.
Repayment Frequencies	Loan repayment frequency in the Bank is monthly.
Collateral Requirements	For greater amount of loans, the Bank required formal collaterals. The accepted collaterals are land, buildings, and vehicles. For smaller amount of loans, the loans are typically unsecured by collateral.
Interest Rates and Fees	The price of the loan reflects several issues, especially the risk level. The higher the risk, the higher the rates of interest charged. Since microloan is categorized as high risk loan, the Bank usually charged the consumer with higher interest rate compared to regular loan offered by commercial banks, to substitute the insufficient collaterals possessed by clients.

The difference schemes applied for different loan products as described in Table 3.2 exist as justification to different level of credit risks faced by the Bank. Each products, specifications, and loan processes is documented properly in the Bank's credit policies and applied equally at all branches of Bank XYZ nationwide. This credit policies is reviewed and developed by Credit Policy and Support under Business Group in order to cope with the Bank's business development.

MFIs commonly adopt conservative product design features to minimize credit risk, such as short loan terms and frequent repayment periods – might be weekly or bi-weekly, but such requirement isn't applied in Bank XYZ. The management believes that collecting repayment on monthly basis is adequate to fulfill their risk appetite. Besides, clients can only apply for loan in their house or business area. This is intended to gain easier access regarding the characteristic of clients and business for better credit assessment.

Second way to implement preventive control is by client screening. In Bank XYZ, account officers are equipped with trainings to be able to review loan applications properly. The goal is to have an acceptable degree of confidence that the loan will be repaid, considering all aspects of the five Cs – character, capacity, capital, collateral, conditions. The difficult part in microlending is that the creditworthiness assessment can't depend heavily on clients' financial report as other regular banking organizations. There are several reasons, first, because not all clients have proper bookkeeping thus they can't provide the financial report required by the Bank – as alternative, generally the clients just provide the Bank with the information about amount of income generated for the past few years. Second, there is no reliability assurance of the financial information provided by the clients since it is unaudited. Therefore, alternative procedure should be taken in order to gain higher confidence level. Alternative methods for screening client's character and the application in the Bank are presented in Table 4.2.

Table 4.2 Application of Screening Client's Character Methods in Bank XYZ

Methods for Screening Client's Character	Bank XYZ's Application Checklist
Check personal and community references to assess the applicant's reputation.	Yes, often.
Use peer groups in which clients select other group member who they believe are honest and reliable.	Rarely done.
Maintain a blacklist of past poor performers to avoid repeat lending to bad clients.	Yes, in certain area.
Interview client to understand his or her motivation for borrowing money.	Yes, always.
Check credit history with suppliers, other credit organizations, or with credit bureau.	Yes, if applicable.

Detailed explanations regarding client's character screening practice in Bank XYZ are as followings:

- Check personal and community references

  Checking applicant's reputation and testing applicant's information in micro loan business is way more complex that those in consumer loan or corporate loan. There are several certain assessments that need to be done that we can't find in other commercial loans.

  First, since the credit risk exposure is heavily relied on client's character rather than the business itself, the loan officers includes interview with neighbors and community's opinion leader in their interview agenda.

  Second, to ensure the validity of information provided by applicant, loan officer visits the household and/or business. Thus the loan officer checks other sources regarding the reliability of the information, such as landlord regarding the size of rent or a supplier regarding the frequency and size of inventory purchases.

- Maintain a blacklist of past poor performers

  Based on past performance and by looking at nature of the business, Credit Review has conducted general analysis and has established policies on client groups that should be avoided, such as gangster, cops, actress/actor.

Furthermore, in-depth analysis toward loan portfolio is needed, by segmenting the loan portfolio based on the clients' business and monitoring the repayment behavior. This type analysis should be done at each branches and the result is communicated to the headquarters as input to branch-across analysis. Unfortunately, this type of analysis hasn't been done yet in Bank XYZ. List of bad performers also kept in certain branch, and didn't communicate to other branches.

- Interview client to understand his or her motivation for borrowing money

  This is general procedure of assessing credit worthiness, that is usually also applied to other types of loan by regular commercial banks.

- Check credit history with suppliers, other credit organizations, or with credit bureau

  This is also regular client screening methods that should be done, including BI checking.

All of procedures done to assess the creditworthiness of the clients are required to be documented properly, such as Survey Report, photocopy of identity card, collateral appraisal (if any), BI checking, and many others.

In the next phase of loan application, after account officers input all data regarding loan application into Credit Application System (CAS), Credit Committee will analyze those data according to their level's limit of approval as depicted in table 3.2. If a loan application amount exceeds the approval limit in the respective branch, then the loan application should be ask for higher-level approval.

When the loan has been approved by authorized Credit Committee, Booking Review in respective branch will check the completeness of loan documentation. Before loan documentation completed, the loan can't be disbursed because any incomplete documentation may cause improper assessment, thus increase the default risk.

Additionally, the Bank insures its loan portfolio to mitigate some of its credit risks. This is a good way implemented by the Bank to share its credit exposures to other third parties

b. Detective Control

Level of credit exposure faced by the Bank can be detected through portfolio monitoring. Portfolio monitoring is done periodically by Risk Management Division, at least every end of month, and the results is reported to the Board of Directors. The key indicators being watched by the management are including NPL ratio, CAR, and Reserve Ratio.

- NPL ratio reflects the ratio of non-performing loans compares to total loans outstanding.
- CAR is a ratio of a bank's capital to its risk.
- Reserve ratio indicates the adequacy of reserves related to loan portfolio.

While in more detailed level of controls, there is Post Booking Review in each Region – under the Credit Policy and Support Department supervision – who responsible to review the loan portfolio. Detective controls taken by Post Booking Review includes checking the loan documentation, checking the collateral appraisal, checking the credit memorandum, and capturing the aging schedule of each loan facilities.

c. Corrective Control

There are several ways that a bank can apply to handle non performing loan in order to maximize loan recovery. Certain accommodations, such as loan rescheduling, reconditioning, restructuring can be made for borrowers who are willing but unable to repay. The trigger for loan restructuring may come from customer or the Bank. If a customer faced difficulties in fulfilling repayment terms, he/she could ask for loan restructuring to the account officer even his/her loan portfolio is still unclassified as non-performing loan. The other trigger takes place when through periodic review, Post Booking Review found that a loan doesn't show good repayment schedule, thus informed the related account officer who handled that loans to offer loan rescheduling. Regardless the initial trigger came from, the loan restructuring should been asked for approval from Credit Committee.

In Bank XYZ, the most common technique to enforce the repayment is through rescheduling. By extending the loan terms or reduce the interest rate, the management hopes that the client will be able to repay their loans and thus reduce the Bank loss. In case client shows uncooperative behavior, the case will be brought to the court.

4.2.2 Fraud Risk and Control Procedures

As other banks, Bank XYZ is exposed to fraud risk in financial operations, procurement, and other operational areas. The common fraud risks are kickbacks from procurement contracts, misuse of petty cash, false claims for travel reimbursement. But related to the microlending process, the Bank faces several fraud risks as followings: as presented in Table 4.3.

- Loan officer issues loans to "ghost" clients.

  This fraud risk takes place in loan disbursement process. Based on historical data of the Bank, the frequency of this fraud is low, but resulting in high impact. The impact of this fictitious loan is the loan goes default, thus the Bank can't get back its money.
- Loan officer charges clients an unofficial "fee" to apply for a loan.

  Based on reports from operational audit done, occurrence of these fraud risks is high. Although it doesn't contribute direct loss to the Bank, but it can bring negative impact toward brand image of the Bank thus decrease the customers' loyalty.
- Data manipulation in order to pass the loan application, such as disclosure of fictive collateral, unfair appraisal of collateral.

  This is a frequent fraud practice that happen in Bank XYZ. Many information presented was not properly tested for validity, and sometimes manipulated in order to achieve high rate of new loan realization. Without proper assessment of clients' information, the information may mislead the credit granting decision and thus lead to high NPL ratio in the future.
- Collusion with clients to increase loan size.

  This type of fraud takes place when account officer grants permission to a loan application that exceeds the client's eligibility. Usually, account officer will get additional fee for such practices. By disbursing loan beyond the client's repayment capability may decrease the repayment rate in the future and increase NPL ratio.

- Loan agreement and disbursement is done outside the Bank.

  Although the occurrence of this fraud risk is low, it brings significant impact to the Bank. Loan agreement and disbursement outside of the Bank, for example in the hospital may cause the absence of legal substance of loan agreement thus the Bank can't enforce the repayment of the loan.

- Incomplete supporting documents but the loan applications is still processed to the next step.

  This type of fraud ranks the first place in terms of frequency in Bank XYZ. Usually it occurred by collusion between account officer and team leader by eliminating several procedures of assessment and providing only several of required documents. Due to incomplete supporting documents, the assessment can't be done properly, thus may lead to wrong decision making.

- Loan officer collects payment, issues receipt, but does not deposit.

  This type of fraud risk takes place in loan repayment activities. The impact of this fraud is increased in NPL ratio, while no repayment can't be enforced from the clients, since in fact the customer have paid.

- Agents collecting loan payments do not deposit them in a timely manner

  This type of risk happened less frequent and brought less significant impact to the Bank. But still the management of the Bank should be aware of the impacts, that is the bookkeeping is done in inappropriate cut-off. Moreover, it may lead to incorrect presentation of financial statement.

a. Preventive Control

Existence of policies to manage credit that approved by the Board and ensuring lending staff comply with the approved lending procedures is the basic step in managing fraud risk. Therefore, Bank XYZ reduces fraud risks through implementation of several operation controls as followings.

- Maintaining excellent portfolio quality

So far, the Bank is able to maintain excellent quality of microloan portfolio. The composition of the Bank's loan portfolio based on collectibility (days past due) classification as of December 31, 2011 and March 31, 2012 as shown in Figure 4.1 indicates that the amount of loans with current classification is more than 90% of total loans portfolio.

Excellent portfolio quality provides a good control environment to reduce fraud risks. This relies on the fact that portfolio quality is mainly created and safeguarded by Account Officers. Due to significant role of Account Officers, vulnerabilities of fraud faced by the Bank is greater. Bad performance of loan is not always, but may become one indicator of fraud. Then, it will be easier to track this possibility if there were only small amount of bad debt.

Figure 4.1 Loans Portfolio of Bank XYZ Based on Collectibility Classification as of December 31, 2011 and March 31, 2012

Source: internal data of Bank XYZ

- Human resources policies

The first layer of prevention using human resources policies is by hiring personnel with high moral integrity. There are several methods for screening employee's character:

Table 4.3 Application of Screening Employee's Character Methods in Bank XYZ

Methods for Screening Employee's Character	Bank XYZ's Application Checklist
Conduct personality and psychological tests that assess the potential employee's character.	Yes, but not always done as psychological test is not mandatory requirement in recruitment process.
Check past employment and personal references, such as: - Ask former employers whether they would hire this person again, - Ask personal contacts whether they would entrust their money to this person.	Rarely done.
Interview and ask employees questions to ask their ethics.	Yes, always.
Hire for a trial period to review employee's character and behavior.	Yes, sometimes.

Human resources policies regarding employee compensation is also important. Attractive salaries, incentives, bonuses, and career opportunities have been taken into management's consideration. By giving salaries that allows an employee to enjoy a reasonable standard of living, the employee will not feel such a strong inclination to support his/her wages to pay for the basics thus reduces fraud risk. In the other hand, negative consequences for inadequate job performance are also informed to prevent employee fraudulent activity.

Bank XYZ doesn't enforce staff rotation (staff here refers specifically to loan officers) as a tool to prevent fraudulent activities. Although staff rotation can be an effective tool to uncover errors and fraud in other organizations, but it is not recommended to be applied in MFIs, since it undermines the relationship between a loan officer and the client whereas the good relationship between a loan officer and the client is one of factors that enhance the loan repayment in MFIs.

- Management Oversight

The Board of Directors, together with management are responsible for setting “tone at the top”, ensuring that the Bank has programs and controls to address the risk of wrongdoing, and ensuring that such controls are effective. Management reviews the existing policies and standards to ensure that it copes with current business of the Bank. Thus through his or her leadership, the management is expected to carry out the highest levels for ethical and responsible business practices to bring positive influence. In branches or sub-branches, Area Lending Manager and Team Leader who supervises Account Officers is held responsible to set the ethical tone of the organization and foster a culture of high ethics and integrity.

- Decentralized Accounting

Branch networking system in Bank XYZ treats each branch as profit center, except for Ladies Branch. By having each profit center account for its use of money, this allows for easier identification of problems when they are small.

- Credit Policies and Procedures

Table 4.4 Credit Policies and Procedures in Bank XYZ

Key Controls	Required Controls	Control Practices in Bank XYZ
Simplicity and transparency	• Products and delivery systems are simple and straightforward by minimizing discretionary authority of loan officer.	• Loan officers are allowed discretion for loan size, interest rate, but there is limitation of loan size, interest rate charged, and standardized loan terms. • Loan disbursement and repayment collection is monitored daily in each branch.
Segregation of duties	• Employees responsible for disbursing loan payments should not be able to initiate and authorize loan transactions. • Employees responsible for recording loans in the general ledger should not be involved in initiating or authorizing loan requests. • Loan documents and custody of collateral for loans should be maintained by employees not involved in the loan process.	• Account Officer is responsible for initial client screening and propose the loan application to the Credit Committee. • Credit Review and other members of Credit Committee is assigned to review the loan application and make decision upon loan approval. • Booking Review responsible to check the completeness of loan documentation before the loan is disbursed.

Table 4.4 Credit Policies and Procedures in Bank XYZ (continued)

Key Controls	Required Controls	Control Practices in Bank XYZ
Segregation of duties (continued)	• Employees responsible for the receipt of cash should not have access to record or authorize transactions in the accounts receivable ledger and customer accounts. • Activity in loan accounts should be reviewed and approved by someone other than the employee responsible for recording transactions in this account.	• Credit Administration is assigned to record the loan transactions into the banking system. • Operating Officers is assigned to execute the loan disbursement once it has approved. • Loan payment is done through client's account in Bank XYZ, so teller is the one responsible for the cash receipt. • Note: Presence of Credit Review and Credit Administration is mandatory in every loan disbursement process. But in the absence of Booking Review, the function is replaced Head Sunries (middle manager in the sub-branches).
Approval authority	• Restrict the ability for one employee to obtain loans from the Bank without written authorization from Credit Committee. • More people involved in the review process, higher level of authority reduce collusion among employees.	• Bank XYZ has applied multi-level loan approval authority. Greater amount of loans poses greater risk to the Bank, thus it is expected by incorporating more parties in the loan application assessment can reduce the possibility of fraud. Besides, higher level in the organization structure is considered to have more skills, higher sense of belonging toward the company, so the possibility of doing fraud that will harm the company's sustainability is relatively smaller than the lower officers.

Table 4.4 Credit Policies and Procedures in Bank XYZ (continued)

Key Controls	Required Controls	Control Practices in Bank XYZ
Dual controls	• Every loan must be approved by at least two persons. • Member of Credit Committee should meet all applicants before they receive the loans or conduct other alternative methods to ensure that client visit has been done and the assessment report of customer and business is made based on true condition.	• Bank XYZ sets a Credit Committee, consisting of more than one employee, to approve loans, and thus spreading the responsibility and authority of those approvals over several individuals. Composition of Credit Committee can be seen in Table 3.2. • Assessment report of customer and business is made and signed by Account Officer and Team Leader. • Team Leader should make Verification Report that reflects client's information. This is useful to minimize "blind signing".
Design and use of adequate documents and records	• Loan documents should be forwarded to an employee who is responsible for recording such activity in the banking system. • Use of standardized, pre-printed, pre-numbered loan agreement forms.	• After Booking Review checked the completeness of loan documentation, the documents is passed to Credit Administration to prepare input to system. • Credit Administration keeps the loan documentations.

Table 4.4 Credit Policies and Procedures in Bank XYZ (continued)

Key Controls	Required Controls	Control Practices in Bank XYZ
Design and use of adequate documents and records (continued)	• Loan agreement should include borrower's name and signature, identification number, unique reference loan, loan amount, interest rate, payment schedule, description of collateral (if applicable), definition of late payment, and penalty for late payment. • Repayment receipt contains date, amount, and payer's signatures.	• Loan agreement form is not pre-numbered. Reference code is realized at the approval date. • Booking Review ensures all necessary supporting documents are fulfilled before the loan is disbursed, such as Loan Application Form, Loan Approval Memorandum, insurance files, proof of collateral, appraisal result, Loan Agreement, etc along with required approval signatures. • In case of arrears, Account Officers are allowed to collect payments from clients. Payment slip issued contains date, amount, and payer's signature, but this document is not pre-numbered.

- Communication and Training

The established values, code of conduct, policies and procedures is not enough. It is required to be communicated to all related employees. Making employees aware of their obligations concerning fraud and misconduct begins with practical communication and training. Therefore, for the established policies and procedures, branch trainings are arranged. Besides, trainings are also conducted to improve staffs' knowledge and awareness about assessing creditworthiness.

- Client education

Unfortunately, in Bank XYZ there is no credit policies and procedures that requires client education. It would be great if the Bank can add client education in the lending process. Clients are required to be introduced to an education campaign to encourage clients to speak out against corrupt staff and group leaders. By educating the client about the Bank's policies, procedures, and channels of complaints and concerns, the employee's activities dealing with client is also monitored by third parties.

b. Detective Control

Understanding the symptoms of fraud is the key to the detection of wrongdoing. Several symptoms of fraud include increases in past due accounts, delinquency of new loans in short period time since initial disbursement, missing documentations, controls of total checks received does not balance to checks deposited, customer complaints, general ledger does not balance, and many others. In order uncover any fraud occurred, the Bank involves elements of detective controls as followings.

- Operational Audit (Internal Audit and Post Booking Review)

In Bank XYZ, there is periodic operational audit to check and review the loan portfolio by Internal Audit and Post Booking Review. The procedures of check and review include checking loan documentation and conducting client visits. In MFI, it is not feasible to check all loans since the loan portfolio consists of numerous small-size loans unlike in traditional financial institutions where loan sizes are larger and the number of active borrowers is fewer than MFI. Checking all loans of the Bank would be inefficient since the cost can be extremely high, exceeded the benefit gained by the Bank.

So, the first step taken is analyzing each branch's portfolio. For the branch where more symptoms of fraud is found, the reviewers take more samples rather than for the branch where there is less symptoms of fraud. The next thing done is by checking loan documentation and thus continued by conducting client visits if necessary.

- Client sampling

  The most effective way to discover various frauds that might take in lending process is through client visits, since the information comes from direct external parties. But in order to save the costs, client visits in Bank XYZ are triggered by the existence of non-performing loan, especially when a loan arrears or becomes default abnormally, for example a client is not able to repay his/her loan since the first day of repayment. From those event, the management should suspect that the loan is probably fictitious loan and to prove it, client visits need to be conducted.

  Besides to catch fictitious loans, client visits are also useful to give information whether there is any kickbacks or illegal fees charged by the account officers to the clients, or any inappropriate loan disbursements done. Presence of kickbacks or illegal fees in credit disbursement activities should be awared since it usually comes from borrowers who considered ineligible based on the Bank's requirements.

  By interviewing the clients, we can also ensure whether the repayment is done timely or not and thus, cross check the information obtained from the clients to the journal record.

- Communication channel of customers complaints

  The Bank hasn't provides a channel to accommodate customer's complaints. The Bank should set up this channel since every customer's complaints is valuable feedback to the organization, not only to detect fraud but also to improve operational activities.

- Reconciliation

  For any differences of Bank's assets bookkeeping and Bank's assets recorded by third parties, the Bank should prepare statement of reconciliation. Third party is a reliable source of information, thus any mismatch with third party record should be traced.

c. Corrective Control

The Bank needs to strictly enforce the rules and regulations and do it consistently. When fraud is identified, as described in Table 4.3, the management of the Bank gives punishment to the perpetrator. The negatives consequences given can take form in warning letter, employee mutation or transfer, firing staff, or even the use of court system in case the perpetrator refuses to pay back what they have been stolen.

Besides, the former control and procedures of the Bank is revised in order to reduce the recurrence of the same fraud risks in the future.

Table 4.5 Revised Policies and Procedures as Response to Fraud Risks in Bank XYZ

Fraud Risks	Proper Control Activities
• Loan officer issues loans to "ghost" clients.	• Credit Committee should check personal and community references and conduct client visits – considering the cost and benefit – to ensure that existence of clients. • Booking Review is assigned to check the completeness of loan documentation before the loan is disbursed. • Post Booking Review should check the loan portfolio, the repayment pattern, and conduct client visits for selected samples.
• Loan officer charges clients an unofficial "fee" to apply for a loan.	• Loan fee is stated in the loan agreement so the client and other third parties can assess the fairness of the charges. • Post Booking Review should conduct in-depth interview with the clients.
• Data manipulation in order to pass the loan application, such as disclosure of fictive collateral, unfair appraisal of collateral.	• Credit Committee consists of two or more persons to assess the loan application. • Post Booking checks collateral documentations and physic of collateral – if the cost is smaller than the exposure or benefit.
• Collusion with clients to increase loan size.	• Credit Committee should ensure whether loan product is eligible for the clients by checking the fairness of assessment report of customer and business, through market research or client visit. • Post Booking Review should conduct in-depth interview with the clients.

Table 4.5 Revised Policies and Procedures as Response to Fraud Risks in Bank XYZ (continued)

Fraud Risks	Proper Control Activities
• Loan agreement and disbursement is done outside the Bank.	• Loan agreement is prohibited to be taken outside of the Bank and should be kept by Credit Administration (to segregate the custody functions from the Account Officer).
• Incomplete supporting documents but the loan applications is still processed to the next step	• Screening employee's characteristic – looking for the one with high integrity. • There will be sanctions for violation of credit policies.
• Loan officer collects payment, issues receipt, but does not deposit.	• Post Booking Review conducts client visits. • Offer good incentives to Account Officers who maintain good portfolio. • Check historical repayment data.
• Agents collecting loan payments do not deposit them in a timely manner.	• Offer good incentives to Account Officers who maintain good portfolio.

4.2.3 Security Risk and Control Procedures

As regular banking organization, MFI is exposed to theft of assets, cash or office assets. The vulnerability of theft of cash is higher than other office assets since the inherent risk of cash itself – cash is the most liquid financial instruments that can move from one hand to another hand easily and no ownership proof written on it – and the inherent risk of banking organization that disburses and receives money directly. But, risk of theft of office assets, such as desk, chairs, computers, is also exist, although the exposure is not as big as theft of cash.

a. Safety of Cash

As other regular financial institutions, one way to reduce the threat of cash theft is by conducting the Bank's financial transactions through local banks. One of the Bank's policies to accommodate this control is by requiring its borrowers to open account in Bank XYZ, so the loan repayment is advised to be done through the bank account.

But due to the operating activities, the Bank also handle some amount of cash. In this case, every branches is guarded by security and in case of transporting money to a central depository or between branches, the Bank hires security services.

Other strategy that is also implemented by the Bank to manage the security risk regarding cash, is risk mitigation to the insurance company by buying insurance premium for cash in safe and cash in transit.

b. Safety of Office Assets

Bank XYZ still doesn’t have updated fixed asset register until now. Currently, the existing fixed asset register is being reviewed. Tagging of internal fixed asset serial number to the office assets hasn’t been attached as well. Overall, the controls regarding theft of office assets is in the Banks is considered as low.

4.3 Information and Communication

In order to improve the information and communication in the Bank, the management has established Management Information System Division. The division’s responsibility is to develop the communication channel within the Bank and to ensure that important information are communicated to all related personnel. Current systems is able to provide the relevant, correct, and timely information, such as financial report, policies and procedures. Therefore account officers and other internal related parties can assess the updated information through intranet and then implement it appropriately.

Information systems in Bank XYZ can also limit one’s access to the system thus increase the security of the system and ensure that information stored inside is accurate.

4.4 Monitoring

Internal control is not a one-time implementation, but it is a continuous process, therefore one of its elements is monitoring activities. As mentioned in Chapter, there are two types of monitoring activities. The first monitoring activity is ongoing monitoring activity. Ongoing monitoring activities include periodic review, taking remedial action and improving further prevention control. For this type of monitoring activities, the detailed analysis and discussion refers to discussion about detective control activities and corrective control activities in section 4.2.

Regarding the second type of monitoring activity, that separate internal control evaluation, this element is fulfilled by the existence of Internal Audit Division at Bank XYZ. The division proactively conducts the analytical review and also periodically reviews the branches' operation by conducting branch visit every month.

CHAPTER 5
CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusion

Two fundamentals requirements for the profitability of MFIs are excellent loan portfolio quality and high efficiency of lending operations. Especially in Bank XYZ which its business focus on micro and small loan, efficiency in the lending operations contributes essentially to the overall efficiency of the institution. Therefore, all risks related to operational activities should be managed wisely, including credit risk, fraud risk, and security risk, especially those in lending process.

The management has proven their concern regarding those risks by the existence of current internal control systems. Internal control is a one-time implementation, but it is a continued process so the existence of current internal control systems of Bank XYZ should be evaluated for a better risk management. Analysis of internal control components at Bank XYZ can be summarized as followings:

a. Control Environment

- Functions of the Board of Directors and the Audit Committee is properly designed and implemented.
- Management's philosophy and operating style show high concern towards policies and procedures.
- Organizational structure is designed to promote collaboration between related divisions.
- Authority and responsibility is clearly described through organizational structure.
- Authority and responsibility is clearly described through organizational structure.

b. Risk Assessment and Control Activities

The Bank uses three types of control activities to manage their operational risks. The summary of control activities toward each type operational risk are described in Table 5.1 below.

Table 5.1 Matrix of Micro Financing Internal Control at Bank XYZ

Risk \ Control	Prevention	Detection	Correction
Credit Risk	• Loan product designs, includes: ~ eligibility requirements ~ loan amounts ~ loan terms ~ repayment frequencies ~ collateral requirements ~ interest rates and fees • Client screening, through: ~ Check personal and community references ~ Interview client ~ Check credit history	• Portfolio monitoring: ~ Non Performing Loan (NPL) ratio ~ Repayment Rate ~ Capital Adequacy Ratio	• Loan rescheduling • Revised loan product designs based on loan portfolio segmentation
Fraud Risk	• Maintain excellent portfolio quality • Employee's character screening • Offer good development and compensation program for employees • Management oversight • Decentralized accounting • Establishing credit policies and procedures • Communication and training • Client education	• Operational audit (including internal audit and post booking review) • Client sampling • Communication channel of customers complaints • Reconciliation	• Employee's reward and punishment • Revised policies and procedures
Security Risk	• Conduct financial transactions through local banks • Maintain fixed asset registry	• Cash count • Stock opname	• Law enforcement • Revised policies and procedures regarding cash and fixed asset

c. Information and Communication

The current management information systems managed by the Bank is adequate to capture and provide information regarding performance of loan portfolio.

d. Monitoring

Internal Audit Division has done its function properly by conducting analytical review and branch visits regularly.

Overall, the current policies and procedures of Bank XYZ can be categorized as adequately designed. But unfortunately, the implementation of those operating procedures still can't provide reasonable assurance for achievement of organizational goal due to lack of enforcement. Policies and procedures as preventive controls exist but some of it left just to be written procedures thus the implementation of internal control systems more depend on detective controls.

5.2 Recommendations

Based on analysis done, below are proposed recommendations to Bank XYZ:

- Bank XYZ should strengthen its human resources policies and procedures considering that micro finance is a labor-intensive business. Employees' role toward achievement of organization goal is very significant, especially account officer. Therefore, in hiring areas, the Bank should conduct in-depth employee's character screening and in development area, the Bank should conduct sufficient training to equip its loan officer with required knowledge and skill to be able to do proper assessment regarding clients' credit worthiness.
- The Bank is advised to develop client profiling. Client profiling is useful to capture the clients' credit risk based on its characteristic, business, and geographical location. It starts with dividing the Bank's loan portfolio into several segments based on business and geographic location. Thus from the

segmentation, the credit review should make periodic report to monitor each segments' recovery rate. Segments with high NPL ratio should become alert for the management to revise its loan terms toward those certain business segments.

- It also would be better if the Bank could develop an internal credit scoring to quantify the credit risk assessment to give better picture regarding client's credit worthiness.
- Client's performance also should be documented in the Bank's system properly so that all related parties could gain easy access toward client's information. This could contribute to more efficient assessment of the same clients in the future. From the data, the Bank could also offer greater loan facilities or lower interest rate as reward for clients that showing good repayment behavior, thus result in creating customer loyalty.
- Other weakness of the Bank is weak enforcement of existing policies and procedures, so it raises the chance for the employees to do fraud. The Bank should establish more strict policies regarding employees' reward and punishment, including firing fraudulent perpetrator or by taking the case to the law. In the other hand, for employees that showing good performance should be given adequate reward. By applying such policies, it is expected that employees will contribute the best of their capabilities to achieve the organization goal.
- In terms of physical assets safeguarding, the Bank should maintain the fixed asset registry and reconcile between the recorded amount and the physical assets.

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APPENDIX 1.

Financial Highlights of Bank XYZ as of December 31, 2011

Financial Data (in million Rupiahs)	2007	2008	2009	2010	2011	2010-2011 Growth Rate
Total Assets	1,214,748	1,342,949	1,283,018	1,405,460	5,393,735	283.77%
Loans – gross	805,847	845,348	932,454	551,476	3,198,902	480.06%
Total Liabilities	1,110,178	1,263,591	1,325,043	1,174,553	4,976,818	323.72%
Deposits from customers	1,032,459	1,190,446	1,177,215	1,043,836	4,790,260	358.91%
Total Equity	104,569	79,358	(42,025)	230,907	416,917	80.56%
Interest Income	157,818	159,175	167,320	104,170	464,349	345.76%
Interest Expense	88,216	90,847	90,455	68,486	246,106	259.35%
Net Interest Income	69,602	68,328	76,865	35,684	218,243	511.60%
Other Operating Income	5,353	5,531	6,884	24,327	69,777	186.83%
Other Operating Expenses	64,508	82,179	90,473	106,913	468,005	337.74%
Net Operating Gain (Loss)	(9,147)	(19,308)	(153,506)	(140,691)	(152,651)	8.50%
Gain (Loss) Before Income Tax	1,545	(25,216)	(101,422)	(149,681)	(154,418)	3.16%
Net Gain (Loss)	642	(28,811)	(121,383)	(79,781)	(132,528)	66.11%
Financial Ratios (%)	**2007**	**2008**	**2009**	**2010**	**2011**	
ROA	0.05	(1.80)	(7.09)	(11.61)	(4.28)	
ROE	(0.55)	(32.67)	(122.12)	(76.00)	(45.50)	
LDR	70.25	63.91	71.29	47.55	60.10	
CAR	10.64	8.41	7.22	37.28	10.82	
NPL Ratio - gross	13.65	13.94	25.12	45.86	8.21	
NPL Ratio - net	13.18	13.11	18.46	3.63	3.56	
NIM	7.43	6.30	6.22	3.16	7.38	
Operating Expenses to Operating Income	90.36	100.53	135.81	141.75	106.82	
# of Branch Offices	17	17	17	17	168	
# of Employees	476	477	411	1,350	6,022	

Source: Annual Report 2011 of Bank XYZ