

# Towards a common approach to risk

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## 1. Why is risk an issue now?

Assessing risks and managing them is not new to development cooperation. In the logical frameworks that summarise each operation, risks should be assessed and a set of actions proposed. Donors' approaches to risk management have evolved in the last decade, and more recently, with the introduction of budget support and the onus on country systems, as documented by the OECD DAC.

Some degree of risk is inevitable in all aid operations. If the governments in receipt of aid were all AAA credit rated, and their financial management and governance arrangements were impeccable, they could fund all their activities through taxation and, as required, finance any deficit by borrowing on the bond markets. Aid is only made available when these conditions do not apply and governments need external assistance.

Donors wrestle to ensure that financing produces measurable results. This is even more acute for those donors that use budget support as their preferred mode of development assistance. It forces donors to focus on country systems as laid out in the broader aid effectiveness agenda.

Frameworks to assess and manage risk have been built on concepts and practices developed by the private sector: this fits well with a project approach and the concept of fiduciary risk. With the change in development cooperation approaches, towards leveraging donors' funds by working within country's systems, the intention is either to reinstate or to strengthen the policy-results chain. This changes the conceptual framework for aid delivery: the risks management (RM) framework needs to be adapted consequently.

The approaches to "fiduciary risk" management that work reasonably well when aid is disbursed through a project approach are therefore much less adapted and less effective when aid management is concerned with achieving results, and this is even more acute when using more arms-length delivery methods as pool funds for sector support and budget support. A risk adverse attitude, largely emanating out of donors' constituencies pressures, coupled to a lack of clarity on existing risks leads to less than optimal decision-making. In this context, reducing the level of one type of risk can lead to the creation of another.

In this short paper, we suggest to 1- identify the potential risks in line with a focus on results and country systems, 2-to classify risks into three broad categories and suggest a common definition, 3-to verify that our assessment framework and range of options to mitigate risks is adequate.

### Key Definitions

The box below provides a summary of key terms that are used in this document when discussing risks, their assessment and management. It would serve as a useful reference for further discussions. These definitions are consistent with definitions used in different sectors and can be applied to any risk context or event. They do not restrictively apply to development cooperation.

### Glossary: Definitions adapted from the UK Treasury<sup>1</sup>

- **Risk:** uncertainty of outcome, whether positive opportunity or negative threat of actions and events is the combination of likelihood and impact, including perceived importance.
- **Exposure:** the consequences, as a combination of impact and likelihood, which may be experienced by the organisation if a specific risk is realised
- **Inherent risk:** the exposure arising from a specific risk before any action has been taken to manage it.
- **Residual risk:** the exposure arising from a specific risk after [effective] action has been taken to manage it.
- **Risk acceptance:** the informed decision to accept the consequences (impact) and the likelihood of a particular risk.
- **Risk appetite:** the amount of risk that an organisation is prepared to accept, tolerate, or be exposed to at any point in time.
- **Risk avoidance:** an informed decision not to become involved in a risk situation.
- **Risk management:** all the processes involved in identifying, assessing and judging risks, assigning ownership, taking actions to mitigate or anticipate them, and monitoring and reviewing progress.
- **Risk mitigation:** the processes built into the controls environment, such as policies, frameworks, accountabilities etc to lower the residual risk
- **Risk Transfer<sup>2</sup>:** process that allow transferring the risk from one party to another, as typically illustrated in a public private partnership or when a private operator insures its operation

### Risk Management: An illustration of the changes and perceived risks

In a recent report, The European Court of Auditors expressed its concern in this way<sup>3</sup>:

*“Funds channelled to the health sector are at particular risk since resource flows to frontline service providers are complex, generally passing through several administrative layers. The Court found that public expenditure tracking surveys or audits tracking public expenditure, although seldom used, have identified public resource leakages on a significant scale in relation to non-wage health expenditures which could have serious consequences for health service delivery. In addition, drug procurement through central medical stores is widely recognised to be a high-risk area.*

*“General Budget Support programmes have not adequately addressed these risks. The 2002 General Budget Support manual foresaw financial audits and compliance tests, particularly in the social sectors, during the course of programme implementation, in addition to the initial appraisal of the quality of public finance management. Such controls are particularly necessary where the capacity of national supreme audit Institutions is low, as is generally the case. However, in practice controls of this kind were not carried out and the Commission dropped the requirement to perform them from its 2007 manual. This states that once the Commission has transferred resources to the national treasury, it will not follow up on how they are used. This is in contrast to the Commission’s policy for Sector Budget Support to examine the use of inputs much more closely ‘paying attention to the results chain from ‘inputs’ to ‘outputs’ to ‘results/outcomes’. The Court shares the view of the European Parliament that this is another advantage of Sector Budget Support in terms of its potential effectiveness compared with General Budget Support”*

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<sup>1</sup> HM Treasury (2004). The Orange Book. Management of Risk – Principles and Concepts

<sup>2</sup> Risk Transfer was not in the UK Treasury Glossary

<sup>3</sup> European Court of Auditors, Special report 10, EU Development Assistance to Health Services in Sub-Saharan Africa, 2008, page 27

Although we may disagree with such sweeping statements on leakages as sometimes made in Public Expenditure Tracking Surveys (PETS) reports, where leakages are mixed and confused with actual funds diversion and embezzlement, the Court highlights the complexity of seeking to achieve and measure results through country systems.

*“In SBS attention is given to the entire result chain and to the allocation and execution of the sector budget. This can be supported by dialogue or conditionality according to the context and the specific objectives of a given SBS programme.”<sup>4</sup>*

In a report on the treatment of risk treatment in General Budget Support operations in ACP, Latin American and Asian countries, the Court of Auditors expressed the following concern:

*“The Commission’s internal guidelines do not provide for the assessment of fiduciary and development risks. The main types of risks are not identified and there is no guidance on how to assess the significance, probability and potential impact of risks. Furthermore, it is not clear how risk-mitigating measures such as capacity-building support, dialogue, conditions and shorter-term measures are to be designed for the different types and levels of risk and how these measures should be coordinated with other donors.”<sup>5</sup>*

The onus, to respond to the Court's concerns, would be on identifying key drivers of risks, read “risk” as attributable to policy-result chain failure, operations management (references are made to the capacity constraints of the EC) and where risks materialise in losses and failures, as risk to the reputation of the institution and its ability to pursue its activities.

## **2. What are the donors’ approaches to Risk Management?**

This section builds on the stock-taking performed by CIPFA and Mokoro<sup>6</sup> on behalf of DfID and the OECD DAC PFM Task Force. It also refers to the OECD DAC and Danida’s publication on managing risk in fragile and transition countries.

DfID has developed its Fiduciary Risk Assessment tool, integrating elements of country systems assessments of formal institutions with informal institutions. The Agence Française de Développement (AFD) has developed a risk assessment based on the PEFA methodology, bearing similarities to DfID’s approach, as a complementary assessment tool to its country analysis. Taking a different approach, The Netherlands developed a political economy assessment tool, SGACA<sup>7</sup>, seeking to integrate the risks emanating out of the informal institutions into the country strategy and dialogue. Finally, the World Bank, a lending institution, is conducting and applying Country Institutional and Procurement Assessments to feed its index IRAI and serve as a basis for determining volumes at risk and modalities, thereby managing risk exposure and appetite concomitantly.

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<sup>4</sup>(ibid, Page 70)

<sup>5</sup> European Court of Auditors, ‘The Commission’s management of general budget support in ACP, Latin American and Asian countries’, Special report 11, 2010, p.19

<sup>6</sup> Stocktake on Donor Approaches to Managing risk when Using Country Systems, CIPFA, Mokoro, May 2008

<sup>7</sup> Strategic Governance and Corruption Analysis, a framework developed by the Clingendael Institute for the Netherlands Ministry of Foreign Affairs, Conflict Research Unit, Sue Unsworth, 2008

## Key findings:

1. All frameworks integrate elements pertaining to formal and informal institutions, but not necessarily explicitly. They use assessments as a basis for determining one or more of three key elements: level of risk, choice of objectives, choice of aid delivery modality.
2. The OECD DAC recognised that donor's capability to integrate risk depends on different legal frameworks and external accountability relations, different internal incentives, i.e. the donors' political economy of their constituencies, organisations and external forces. This emphasises the need for donors to develop a technical case for risk management, making risks visible, explicit and part of the decision-making process, rather than implicit and only recognised informally.
3. Donors have different knowledge and different experiences but these can be harnessed into sharing and harmonising. By using different approaches to risk assessment, donors can cause extra transaction costs, as well inconsistencies in risk mitigation and monitoring. Seeking ways to better harmonise both risk assessment and management was recommended by the CIPFA/Mokoro stocktake and OECD.
4. The OECD 2009 "Better Aid, Managing Development Resources: the Use of Country Systems in Public Financial Management" publication looks at risks that donors may face in using countries' PFM systems and discusses donors' capacity to bear such risks (read "Risk Appetite"). Three categories of risks are defined, though the definitions vary widely in scope and precision: Developmental, Fiduciary and Reputational. Operational risks are also identified though they can be integrated in one of the other three categories. It also concerns the security of contracted personnel and donor assets on the ground and should not be mixed with risk for development cooperation, but be handled through agencies' policies.
5. Development cooperation, when working with Governments, subjects a donor to all three types of risk. This is an important recognition that irrespective of the aid delivery modality, country systems are used and impact on the attainment of objectives.
6. With the focus on country systems, development partners and governments expect that enhancing country systems will ensure that a country develops its capacity to draft policies and achieve results in socio-economic development. But there is a cost: donors have to re-learn how to manage the process.

## Agreeing on Definitions

Adopting the Office for Government Commerce's (OGC, United Kingdom) steps to Risk Management, we need to develop a framework for identifying risks, assessing their likelihood and impact as well as developing specific responses to each of them, from mitigation to acceptance and transfer:

- Risks have to be identified with regard to the institution owning the programme, i.e. controlling its design, implementation and monitoring: in the context of development aid aligned on a country's system, this imposes the need to assess country systems' risks as well as the risks that pertains to a donor's support
- Risks are defined with respect to the objectives of a programme rather than limited to a specific type of risk, as opposed to a focus often restricted to fiduciary risk; the OECD-DAC adopted the input>output>outcome>impact chain

- A risk can be measured using two dimensions: its impact and its likelihood. Risk Management needs to address both dimensions to provide an operational guidance on reducing, sharing or accepting/refusing risk.

A useful introduction is found in NORAD's and OGC's definitions<sup>8</sup>:

*"Risks are closely related to results and should consequently be analysed against the results framework of a programme. There are both internal and external risk factors. Internal risks are factors under the control of the programme that may hinder success, such as corruption, human and financial resource capacity, management capabilities, incentive structures, accountability and transparency, ownership and motivation of staff. External risks are conditions outside the programme, which could have a negative influence on the achievement of results. External risks could be related to political, institutional, economic, environmental, social or technological conditions."*

This is a useful entry point for the definition of "developmental risk". Using the Input > Output > Outcome > Impact sequence, is a useful manner to think about the potential risks and their impact with regards to country systems. We will use it to identify all developmental risks, directly tied to a country's systems and the impact of external factors.

**Developmental risks:** encompass a broad range of risk. They are identified using the Input > Output > Outcome > Impact sequence and are linked to a country's systems and informal institutions. They explain the non-achievement of policy objectives, the failure to monitor inputs, outputs and results, the failure to transmit policy through the budget, the impact of informal institutions (an element of political economy) on formal systems. Country risk, linked to policy changes, political upheavals and civil unrest and macro economic shocks are also included into this category.

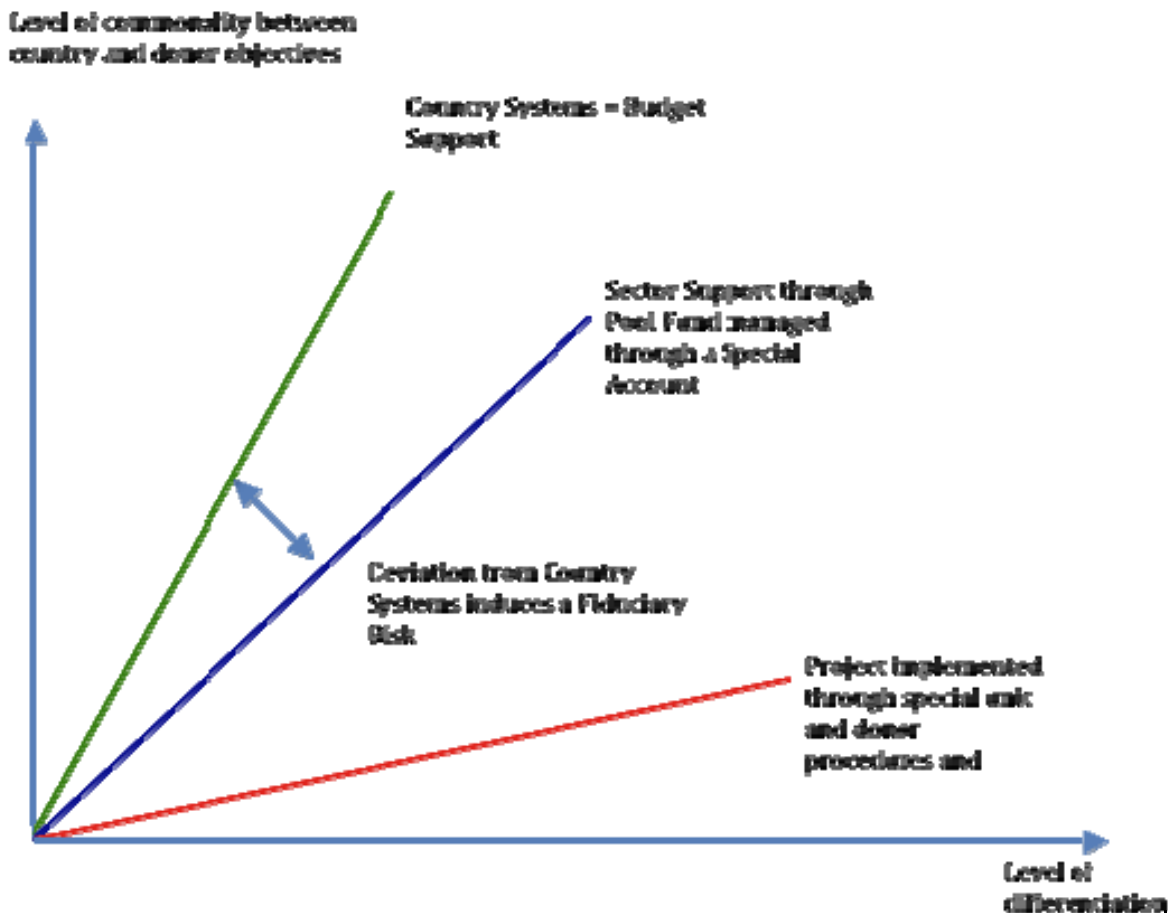
Fiduciary risks have usually been treated with reference to private sector models, and have often encompassed all financial matters. For this reason, fiduciary risk definitions often either treat risk linked to project management or to budget support releases through the Treasury and the use of national resources through country systems. This artificially separates out public financial management systems from the policy making and policy transmission issues.

However, fiduciary risk, in its definition, is directly tied to a "fiduciary" acting as an agent on behalf of the beneficiary. It is better viewed as existing whenever a third party acts between a donor and a government to manage funds. When budget support is used, fiduciary risk is non-existent.

The following diagram provides an illustration:

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<sup>8</sup> Result Management in Norwegian Development Cooperation: A practical Guide. Available on NORAD's website



As this illustrates, whenever a donor uses country systems to the full extent, there is no fiduciary risk. However the support is exposed to all developmental risks. What does it mean? As soon as an aid modality is not fully aligned on country systems, a fiduciary risk is created, while some elements of the country systems risks, normally those linked to the inputs to outputs, are removed. A discussion on risk exposure and on the implication of choices of modalities for objectives is included later. At this stage, it is useful to note the way developmental and fiduciary risks behave and interact.

**Fiduciary Risks:** are defined as the risk occurring when the fiduciary is an agent not acting according to the interest of the beneficiary, in this case the State represented by its development cooperation.<sup>9</sup> The fiduciary is any agent or entity created for managing an aid modality, e.g. the convergence of a project team in a ministry, the National Audit Office and the Delegations of the European Union and its associated specific procedures covering part or all of the financial cycle.

<sup>9</sup> Note that ultimately, the beneficiary is the citizenry of the country, but first this appears too broad a concept, and second, if donors were treating the State as a conduit for channelling resources to citizens and other target groups this would raise fundamental sovereignty issues. Note also that Budget Support (BS) is the closest to full alignment on country systems and can be treated as such. But in practice, cash management is such a fundamental element of PFM and so by BS arrangements that countries having little control over the flow of resources. BS also introduces an element of fiduciary risks through the lack of predictability.

**Reputational risks:** are defined as the perceived likelihood and impact of unplanned events whose occurrence require a donor to significantly change the design of an operation or a country support strategy, abandon an operation or significantly reduce its country support, abandon or significantly reduce the use of a particular aid modality. This is in response to public opinion and constituencies demand or to prevent a perceived risk that such a demand would result in worst-case scenario.

Reputational risks are tied to the perception a donor has of the likelihood of its partnership being hit by corruption or human right abuse scandals occurring through a development aid operation and the impact that it would have on its ability to carry out its work at the operation level, in the country or through the aid instrument. At this point, this perception is largely, though falsely, modulated according to the aid delivery method employed as being low in case of projects but high in case of budget support: this is a fallacy. Reputational risk is introduced by the constituencies' lack of awareness of the context and actionable levers of development cooperation.

### 3. Risk Identification in context

Prior to identifying risks, it is useful to introduce the broad framework within which we work. EuropeAid is now revising its guidance, the Programme and Project Cycle Management -PPCM, including how to assess country and sector contexts. Constructing the Country and Sector Contexts Analyses is based on an assessment of formal institutions and of the political economy of the country and of the sectors. It covers:

1. The PFM systems in a country and how the institutional structure of the State, i.e. deconcentration and decentralisation impact on peripheral service delivery for sectors;
2. The macro-economic context that drives the fiscal space and in turn the policy space and the resistance of the economy to shocks;
3. The national development policies and their coherence with the context;
4. The challenges facing peripheral service delivery, through decentralised service delivery units and/or devolved services, including resources flows;
5. The sector policies and the M&E systems;
6. The Political Economy that drives how policies are crafted and executed through the budget instrument;
7. The Donor Coordination that allows syndicating risks, pooling information, human and financial resources and enhancing dialogue.

Assessing risk requires obtaining a sufficient level of information on the country's systems and their level of application in practice. It also requires understanding how Political Economy impacts these systems. PPCM aims at developing guidance, through a question-based approach and simple analytical frameworks to allow each EU delegation to construct a country context analysis.

Assessing country systems' risks is then a question of using the information derived from each analytical framework and making a judgement on the likelihood and impact of the risks identified in the policy failure framework.

We use the word "judgement" here because it has to be clear to all users that no tool is perfect. Due to cognitive limitations and incomplete information, the level of impact and of likelihood of a risk

will be subjective. It also depends on the organisation's appetite, itself dependent upon its constituencies. Explaining clearly why risks exist, what are the risks and what can or cannot be done about it becomes essential.

That said, making the work "collegial" and using it for both policy and management dialogue<sup>10</sup> could make the appreciation more useful in making decision for managing risks (reducing, sharing, accepting).

*Note: for each of the topics covered by the PPCM for the country and sector context assessments, there already exist methodologies or guidance. There is however a clear need for harmonising different sets of guidance and methodologies to achieve a common assessment, serving as in the case of PEFA, as a common pool of information and a basis for dialogue among the partners, including Government.*

What can be done to assess the risks pertaining to the Donor's Operation Design?

The framework below (Figure 3.1) illustrates how to integrate the assessments that are suggested in PPCM to respond to the need to better assess the country and sector contexts.

A distinction is made between the formal structures and systems such as a country's public finance management system and political economy analysis. Political economy is viewed as an enabling or disabling factor that impacts positively or negatively on existing formal structures and systems. This integration is represented by a multiply sign.

This integration informs the assessment of risks and the choice of the objectives. Although the objectives of a government are not to be changed, a donor may pursue less ambitious objectives, seeking to attain objectives in the form of outputs or intermediary outcomes rather than final outcomes.

This is important as it drives the dialogue and negotiations with the Government on the support operation's design. A clear understanding of the context, whether it fosters an environment where a donor might take risk or whether it reduces opportunities, is fundamental.

Risk exposure is determined by the choice of the aid modality. It is an inherent characteristic of an aid modality. Budget support is the most exposed to developmental risks but does not have fiduciary risk for donors.<sup>11</sup> All other aid modalities induce fiduciary risks but reduce exposure to developmental risks. However, being increasingly parallel to country systems, they do not ripple out and impact all programmes and expenditures management. In turns, this limits the degree to which you can reach objectives.

Indeed, project funding can be characterised as 'buying' something, whether capacity or some level of throughputs to outputs: funds are allocated in order to purchase the means of delivering services, these means being made available for the country systems. Budget support is different, in that

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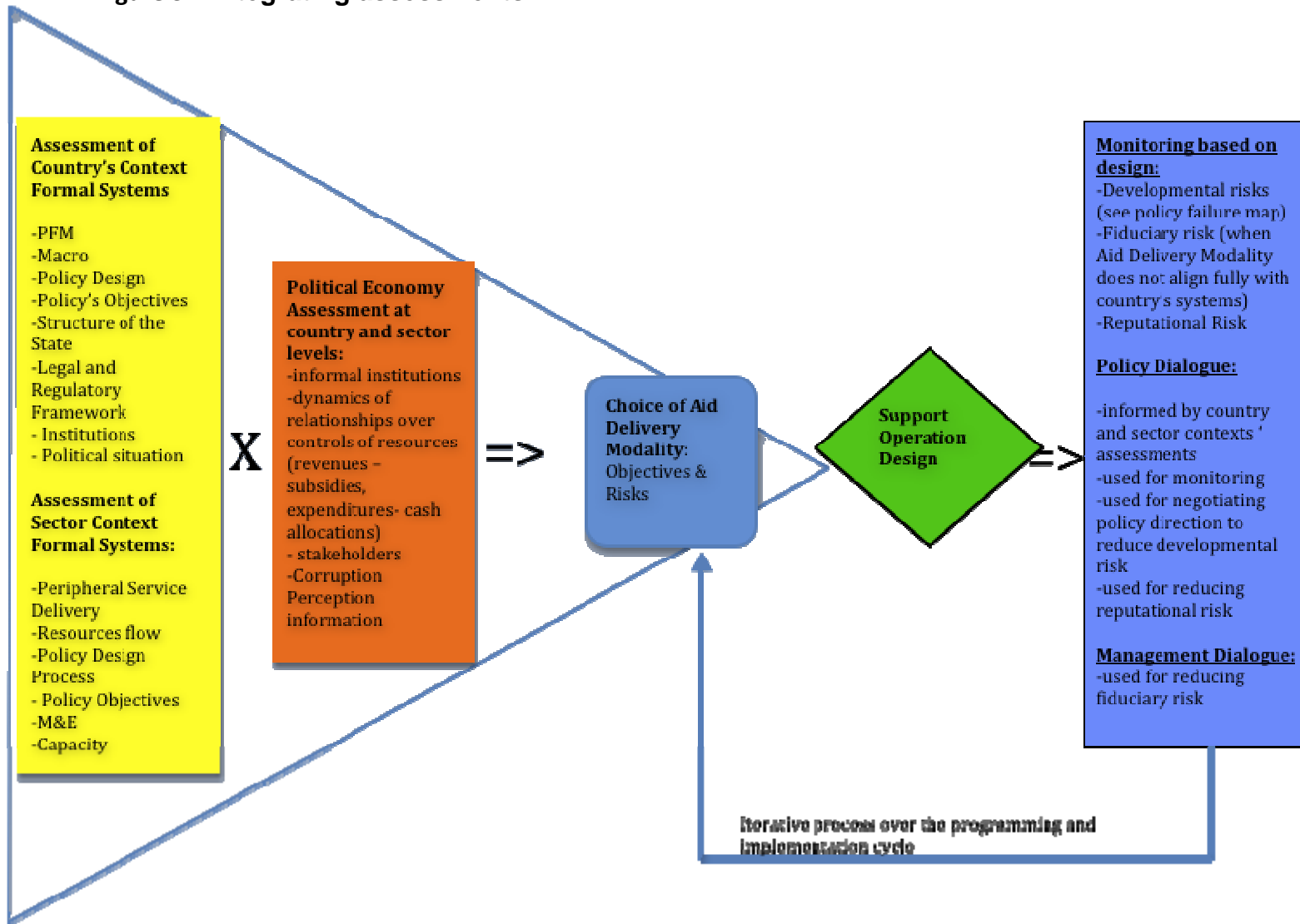
<sup>10</sup> Policy dialogue is defined as the engagement between a donor (or a group of donors), a government and sector stakeholders on the public policies (see cycle in PPCM). Management dialogue refers to all engagements necessary to implement a financing agreement following its signature, including financing, accounting, monitoring, reporting and evaluating.

<sup>11</sup> Budget support is an aid modality whose definition according to OECD DAC implies that aid is released through a country's treasury. Yet it cannot be fully aligned with a country's PFMSystem as the government does not control with certainty the release and timing, thereby creating a fiduciary risk. This can be improved significantly in most cases.

donor funds are merged with national funds to support the government's entire policy cycle, including service design and delivery processes to achieve the results sought by the national programme. The donor funds add to the total funds available to produce results but do not purchase quantifiable outputs: indicators are used to manage the disbursement process.

The choice of aid delivery modality is informed by the risk assessment but remains a judgement, consistent with the donor's risk policy (acceptance and appetite). Reducing risk exposure thus comes at a price: reducing the possibilities to attain more ambitious development objectives by the end of the operation and improve country systems. This impacts what the donor support can help achieve in a country but largely impacts on the country's ability to rely on donor support to fund its policies.

Figure 3.1 Integrating assessments

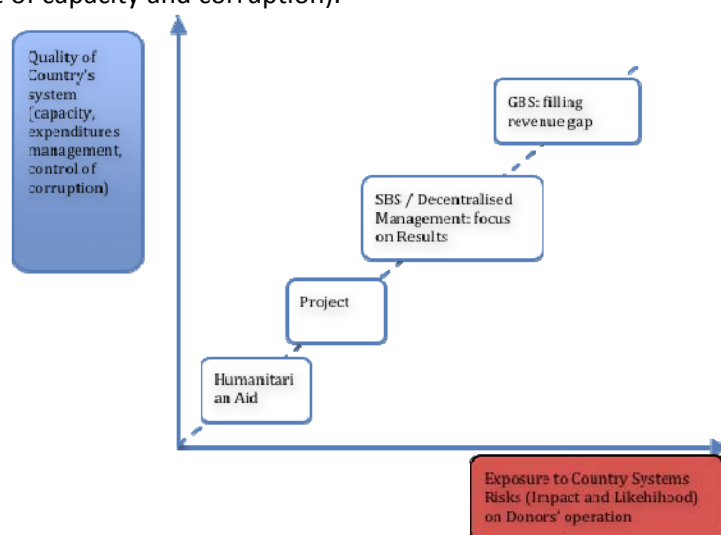


## 4. Risk and aid modalities: the relationship between exposure and goals pursued

As a first step to identify potential risks we propose as a simple framework that all aid delivery modalities respond to a common objective but are different as to the level of risk incurred by using a country's system:

- All aid delivery methods serve the same purpose: to support a government's<sup>12</sup> initiatives and change agents to develop better policies for socio-economic development, and to implement them through the country systems. These structures and systems include public finance management, institutions, (both formal and informal), the relationships between institutions and between interest groups and their dynamics.
- Aid delivery methods vary from indirect support through NGO's to project and budget support. Projects may be in the form of technical cooperation, to build institutional capacity, or to develop infrastructures or a mix. With some exceptions as in the case of humanitarian actions, ultimately whatever the aid modality, the objective is to reinforce the policy-result chain. In this sense, all aid delivery methods respond to the same objective. Donors can "leverage" their aid to impact on government's policies and its transmission mechanism: budget support is simply the aid modality that is most aligned to a country's systems.

As illustrated below (Figure 4.1), it is therefore possible to plot each aid delivery modality based on its exposure to country systems' risks and the quality of such systems (defined theoretically as a composite measure of capacity and corruption).



**Figure 4.1: Quality and exposure to Country Systems**

<sup>12</sup> This framework addresses cooperation with governments. It is evident that it does not apply to decentralised cooperation or direct support to NGOs, civil society's organisations. It is however useful to inform on the likely hurdles to and impact of such cooperation. For example, supporting independent think tank to help reduce corruption or improve policies are activities dependent on the Input >> Impact sequence within the State apparatus.

This simple framework links a country's context and developmental risks impacting on any government programme and the aid delivery method, through its level of exposure to developmental risk. Progressing along the line allows shifting from the donor operation's objectives to fully embrace the country policy's objective. This requires a policy dialogue, informed by an assessment of the country and sector, the monitoring of risks and mitigation measures agreed upon, and the monitoring of outputs and outcomes.

As in any partnership, as the quality of country systems and their management improve, there is an expectation that more exposed aid modalities will be used. Working within country systems and improving them impacts on the effectiveness of all expenditures.

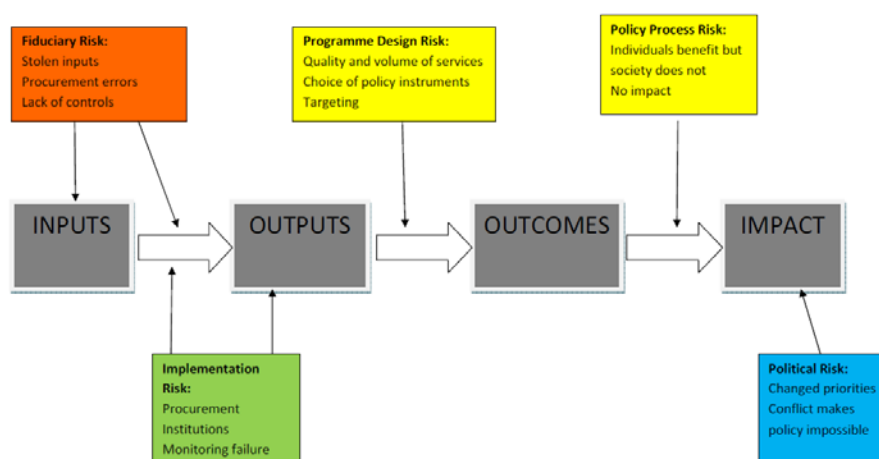
## 5. Risk Identification: Developmental Risk or the policy chain failure

To consider developmental risks, as defined above, we focus on country systems and seek to identify all potential risks along the policy > results chain. The chain comprises all institutions, systems and the political economy at country and sector levels that have an impact on policy making, choice of policy instruments, implementation and the delivery of services, their monitoring and control.

In line with the OECD, we use the Input>Output>Outcome>Impact frame. Untreated risks will result in policy failure, which can occur at any stage of the sequence, from failure to control the inputs, to produce the outputs specified, to choose the right outputs to achieve the desired outcomes, from the outcomes not producing the expected impact and from country's risks and external shocks limiting the outcomes and/or impacts.

These failures can be broken down into categories according to their position on the input>output>outcome>impact chain. The sequence and the associated risks are set out in Figure 5.1.

**Figure 5.1 Risks in the input to impact sequence**



### Financial Management Risks

The first set of risks occur in the financial management arrangements, where there is a series of things that can go wrong to prevent the effective allocation, flow and application of funds. The financial management arrangements are normally those in force according to the legal and

regulatory framework, the institutional framework (usually supervised by the Ministry of Finance and other key institutions) and that apply to the public financial management system as a whole. In assessing the system, the levels of decentralisation and devolution have to be appraised. The quality of expenditure management does not depend upon “what should be” as defined by the laws, regulations and manuals but “what is”.

The risks occur in the following ways:

- Budget preparation is weak and does not permit a realistic costing of activities
- Budget formulation is based on allocation not reflecting expressed policies for lack of fiscal space, constraining budget and leading to arrears
- Funds might be misallocated due to poor controls: while funds are allocated to a policy or programme, the budget execution system is poor and the funds do not arrive at the relevant point.
- Failure of commitment control reducing availability of cash for not yet committed activities
- Inability of the government to inform spending units on budget votes and cash allocations. Even if funds are available, the cash management and information system do not enable the people responsible for spending to manage their cash in a predictable and orderly way.
- Procurement is not adequate and does not allow obtaining economic value, reducing the quantities of inputs accessible. Once funds are allocated, resources are wasted through high prices, poor quality goods and services and their negative impact on outputs.
- Linkages between procurement plans and budget do not exist, leading to poor or no procurement control. For example, procurement of unplanned services or works to respond to new instructions
- Outputs produced are not outputs planned, result of an allocation and budget process that is not protecting against new activities being pushed through at budget execution stage (the budget becomes a “fiat”). Even when funds are made available for the planned outputs, funds can be diverted when new priorities emerge during the budget year. Ministers or senior civil servants direct the reallocation of funds to their new priorities, rather than the ones agreed in the plan and budget.
- Internal controls are weak and do not permit controlling quantity and quality of inputs and managing stores
- Internal controls do not permit reliable recording and accounting, and timely and accurate reporting on budget execution
- Salary expenditures are not based on a set of controls allowing to ensure funds availability for each post, payment to a duly selected and contracted agent, for a period actually worked.
- Stolen: in the case of failed states and grand corruption, diversion of resources from Consolidated Funds, non monitorable bank accounts (as in case where MDAs (Ministries Departments and Agencies are allowed to maintain multiple bank accounts without ability to operate a Single Treasury Account); in wider situations, Internally Generated Funds not reported upon.

### **Implementation risk**

Implementation risk is not necessarily all to be found in the financial management system, but may refer to the management capacity, including monitoring, evaluation and management of physical assets. These may be summed up as the capacity to implement. The main place that implementation risk occurs, in figure 5.1 is in the transformation of inputs into outputs. Failure may occur in the following ways:

- Allocation of responsibilities to institutions with insufficient capacity. When new policies and programmes are planned, they are sometimes given to a set of institutions that find it hard to cope with the new resources. For example, a large capital programme for building and refurbishing schools may be managed by a small, unskilled and stretched education department without the capacity to check and sign off capital spending, resulting in low outputs and poor quality building works.
- Poor procurement processes which mean that the wrong goods and services are bought, resulting in poor outputs. Examples include purchase of the wrong books for the relevant school syllabus, the wrong drugs and other consumables in clinics.
- Responsible officers having insufficient access to risk management resources. Accountable officers need to manage risk, by having control over contracts, authority over staff, the ability to switch resources around if failure is likely. Rigidity and lack of resources increases the risk of implementation failure.
- Negative political economy, whereby the interests in success are not aligned with the most powerful people in the system, thus distorting implementation. Examples include political direction of implementation, such as school building, to areas where the need is not identified as greatest.
- Failure of internal reporting mechanisms, failures being hidden by responsible officers, either in government or development partners. There is a tendency for only good news to travel upwards, both in government and within development partners.
- The external monitoring processes fail to prevent, or prevent too late, implementation failure.
- The wrong indicators are used for monitoring. In some cases, a too narrow range of indicators is used for monitoring. The emphasis on outcomes, for example, which show up in the long term may drive out a concern with measuring outputs, with which problems can occur in the short term.
- The wrong data are collected to represent the indicators. Even when the right indicators are chosen, the data collected may not match perfectly with the indicator chosen. An example would be in an education policy, where one output indicator might be 'the number of pupils engaged in education', whereas the data collected is pupil enrolment, which measures pupils who turn up at the beginning of the school term, not those who are engaged in education.
- Data is corrupted as it is transmitted upwards. In addition to the problem of data being massaged to make it more optimistic, is the physical problem of data collected on forms, summarised and aggregated in ways that produce errors.
- In the case of Public Private Partnerships, processes that work against implementation success. There is a special category of process failure in the case of PPP projects and programmes.

### **Programme design risk**

The outputs are produced as planned but the outcomes are not achieved as expected. This can be the result of:

- The wrong policy instruments were chosen to achieve the outcomes required. A common example is healthcare policy directed towards the poorest in poor countries, where the policy instrument is a series of clinics that require payment of a fee. Another is the

production of clinics and medical interventions when the main health problems are caused by poor water supply and sanitation arrangements.

- The distribution of outputs, to geographical areas or socio-economic groups was not achieved as planned. Targeted programmes may fail to reach the target groups for a variety of physical and administrative reasons.
- The outputs were of insufficient volume or quality to achieve the outcomes. During the process of programme design and budgeting, ambitious targets are often set, which cannot possibly be achieved by the eventual, actual level of resource allocation. While there may be good will to achieve the stated outcome objectives, there may simply be insufficient resources, or 'fiscal space' to achieve the stated levels of achievement. In this case, while politically the higher level ambition may be acceptable, for donors it will result in a reported failure. Better to reduce that risk by setting targets that are commensurate with the actual resource availability.

### **Policy process risk**

The outcomes are achieved as planned but the impact on the population was not as expected. The whole process of policy analysis, with all the stages in the cycle from problem identification to evaluation may not generate the right policies to generate the desired impact.

- The target socio-economic groups were impacted by the programme but failed to make a societal difference. Examples would include a programme aimed at poor farmers, who benefit individually but do not increase food availability more widely.
- The policies produced the expected results but failed to solve the over-arching problems identified. Literacy and basic education programmes, for example, might improve literacy among a particular group, but lack of employment opportunities mean that they do not gain economic benefit from their education.

These two risks, programming and the overall policy process, may be distinguished from the risk involved in the management of programmes and resources: they apply to the high level processes of policy analysis and programme design, prior to the implementation stage.

### **Political Risk and External Shocks**

Resting above the input>output>outcome>impact frame, there are high level political risks to any policy's positive impact:

- A change of government or Minister may result in changed priorities and the policy is downgraded or cancelled. What is a high priority for one party may have lower salience once there is a change in government, reducing the political commitment to particular policy area.
- Societal divisions make implementation throughout society impossible
- Civil strife or unrest or state withdrawal from some areas make implementation uneven
- External economic and financial crisis impede government to pursue the programme due to revenue shortfall
- Election processes leaves the new government with a previous budget deficit putting the country "off-track" with its main partners (financing agreements).

### **Box: Examples of development risks**

#### **Policy design: intersectoral co-ordination**

A food policy aims to increase farming yields and boost output from the agricultural sector, to improve food security and dietary standards. Inputs are subsidised and distributed, farmers are trained and encouraged to increase production. Yields improve and farmers start to produce surpluses. The transport infrastructure is poor, road surfaces do not work in the wet season and there are few available trucks. Food is not distributed to markets. The risk would have been mitigated through better co-ordination between food and transport sectors.

#### **Implementation: poor choice of indicators**

A long programme of developing primary schools, with the aim of improving literacy and other aspects of poor people's education. Sector support is given for school building, teacher training and teacher salaries. The indicator is school enrolment. Enrolment data is collected and is satisfactory. Spot checks on the schools reveal that attendance of pupils in classes with teachers is only 60%. Teacher absenteeism is around 25%. The outcome indicators (rates of literacy etc.) were appropriate but the output indicators were inadequate to ensure risk mitigation. Output indicators flag problems more quickly than outcome indicators. While the outcome indicators are essential for evaluation, output measurements are also essential, for monitoring and identifying problems at early stages of implementation.

#### **Programme design: choice of policy instrument**

A programme of decentralisation was established to enhance local democracy and local service delivery. One policy instrument chosen was the development of local taxation, to provide revenue for the enhanced responsibilities of the local governments. In practice, it was never possible to collect taxes locally and the authorities remained dependent on grants from central government, which were never adequate to provide local services. Risk would have been reduced by a realistic assessment of the feasibility of local taxation.

#### **Programme design: distribution of outputs**

A health sector programme was put in place with an emphasis on primary healthcare for the poorest people. Clinics were built and doctors recruited. The policy was based on user charges, albeit at a subsidised rate. The poorest people were unable to afford the small charges made at the clinics and continued to rely on traditional medical practitioners. The risk would have been mitigated by an assessment of the incomes and spending preferences of the poorest people.

### **Fiduciary Risk**

As indicated above, fiduciary risk is derived directly from the aid delivery modality. Introducing a fiduciary agent, through a combination of institutions and procedures that do not align with the country systems, generate a fiduciary risk.

**Budget Support** (and fully decentralised management in the case of EuropeAid and ELARG): In the case of Budget Support, this risk is considered negligible and can be mitigated. Predictability is the fiduciary risk induced: design and management dialogue will usually reduce it to an acceptable level. As indicated above in the financial management risks for country systems, erratic funding, implying less cash allocations to entities than budget votes, without sufficient a priori notice to adjust plans (when even possible) is bound to impact negatively financial management, likely leading to arrears (commitment made that cannot be honoured).

**Project Support** (and substantially and partially decentralised management): whether for a sector support as part of a pool funding arrangement or a specific institutional capacity building or for a road construction, projects are characterised by being more or less disconnected from the institutional structures and systems of a country. As such and to a varying degree, they are parallel and present a fiduciary risk. Employing technical assistance to manage the project usually mitigates the fiduciary risk. It may prove useful: 1-to distinguish such assistance from capacity development, making it clear that this is a necessary transaction cost to be absorbed by the donor; and 2-to limit the mandate to financial management, including cash management and procurement, accounting and reporting, leaving the programme design and decision on activities, inputs and volumes to the institutions supported.

### **Reputational Risk**

Reputational risk is a different category from any other risks as it is in itself an outcome of the combination of developmental and fiduciary risks, and of the donor constituencies. It is important to note here that their capacity to assess the development cooperation and specific country situation is key to agreeing on risk exposure and acceptance as part of the donor policy. Reputational risk can be further detailed into:

- Risk to the operation: risks that threaten the operation, either in a sector or as a whole but is contained;
- Risk to the Country Strategy: risks that make or may make the country strategy inoperable
- Risk to the Aid Delivery Modality: risks that result in the donor changing its aid modality specifications or fundamentally changing the way it works, possibly even abandoning the principles of Paris/Accra approaches

This risk is not measurable based on assessment. It is rather an agency-specific risk, that each donor will define based on its own political economy. This risk occurs when an unplanned developmental or fiduciary risk occur. Stated as such, the risk is thus one of misinformation of the constituencies'. Mitigation is based on developing better country and sector context assessments as suggested by EuropeAid under the PPCM guidance and accepting that risk is an element of any support. Demonstrating the existence of risks and of specific procedures to manage risk, as proposed here, provides the basis for this mitigation.

## **6. Risk Level Determination and Integration**

Once risks have been identified, their assessment and integration is required. Risk assessment can be done using specific assessments as PEFA for financial management or another methodology, for

example the SGACA for political economy. DfID developed a risk assessment methodology using PEFA and additional data collection including on elements of political economy. However, beyond the data collection and analysis, the assessments identify the country specific risks and then provide a “scoring” to determine the level of risk.

We suggest adopting a similar approach, based on simple risk levels integrated into a matrix format. Such risk level determination and associated matrices on how to respond to specific risk can only remain indicative: they inform decision-making, design, monitoring and dialogue but cannot be taken as formulae to be applied mechanically.

Risk matrices are not suited for every circumstance: they have limitations, mainly from their simplicity, but they:

1. provide consistency and granularity to risk prioritization, using the appropriate level of detail
2. encourage and facilitate robust discussion
3. provide a point of focus when assessing risks
4. present complex data concisely

These objectives correspond well to the needs of development cooperation that require a simple decision framework, concise information for sharing among donors and with Government, and to support management and policy dialogue.

A risks matrix, combining impact and likelihood of different risks, is therefore a powerful tool for supporting decision making: choosing aid modality and determining responses to mitigate, share, accept or reject risk. Whenever a risk is rejected, the decision will necessarily lead to choosing a less exposed aid modality or seek alternative support design to share the risk with other stakeholders.

Risk strategy, the choice of approach to risk, should arise from an iterative process, not a decision itself in response to the analysis expressed in the matrix. This process can only be useful if fully integrated in the internal workings of an agency. As stated above, EuropeAid PPCM guidance suggests such changes to the way Delegation operate. It seeks to build a country and sectors context analysis through a collegial approach. Because risk assessment is also subject to cognitive limitations and incomplete information, it responds well to a collegial approach and requires educating constituencies too.

For each category of risk, two dimensions will be assessed, impact and likelihood. The possibility to reduce the risk through a form of mitigation has then to be commented. Integration means combining these levels together; whether numerically or logically. This simplicity reveals the limitations of the process. We have chosen to retain four levels as used by DfID:

| <b>Impact and Likelihood Levels (DfID, How-to-Note, Fiduciary Risk Assessment)</b> |  |
|--|--|
| Low  | Represents a situation where the structure of the PFMA system broadly reflects |

|             |  |
|-------------|--|
|             | good international practice and there is routine compliance with the majority of controls within the system. Any remaining weaknesses are being addressed.   |
| Moderate    | Represents a situation where the structure of the PFMA system broadly reflects good international practice, although there may be some gaps or inefficiencies. There is basic compliance with controls within the system but regular exceptions occur. There is a credible commitment to addressing key weaknesses |
| Substantial | Represents a situation where the structure of the PFMA system falls short of good international practice in a number of areas and/or there are numerous and/or material weaknesses in compliance with many of the controls within the system. Reform plans may need to be strengthened and prioritised             |
| High        | Represents a situation where the structure of the PFMA system shows a significant divergence from good international practice and/or there is widespread lack of compliance with many of the controls within the system. Commitment to a credible reform programme may be weak.                                    |

For our purpose, we use these four levels with the broad definitions:

| Levels      | Likelihood   | Impact   |
|-------------|--|--|
| Low         | Represents a situation where the risk identified in this framework is unlikely to occur thanks to systems and institutional structures in place.   | Represents a situation where the impact should the risk occur will be limited so as not to disrupt the attainment of objectives, though extra costs may occur.                         |
| Moderate    | Represents a situation where systems and institutional structures should prevent the occurrence but additional monitoring will be necessary. Systems enhancement will be discussed in policy dialogue.   | Represents a situation where the impact should the risk occur will result in budget slippages, delayed attainment of objectives, partial achievement                                   |
| Substantial | Represents a situation where systems and institutional structures will not prevent the occurrence unless a broad set of specific measures are taken, monitored and supported by management dialogue. Agreeing on a broad set of reforms will be part of policy dialogue. | Represents a situation where the impact should the risk occur would significantly disrupt the programme or the policy and result in inefficiencies and ineffectivity for target groups |
| High        | Represents a situation where systems and institutional structures will not prevent the occurrence of risk. Corrective measures and monitoring will be necessary at all levels. Support will be conditional to an agreement on a broad set of reforms.                    | Represents a situation where the impact should the risk occur would result in a quasi failure of the policy-result chain resulting in a loss of budget                                 |

The integration of impact and likelihood levels results in an overall level, rated from low to high and combining part or all of the definitions given above. Any risk that is high or substantial should be

mitigated and reduced to a residual risk acceptable to the agency. For example, the policy could be that risk monitoring, management dialogue and policy dialogue are sufficient measures for low and moderate risks but that high and substantial risk have to be reduced to low or moderate, through specific measures and inputs.

In some instances, risk assessment practice involves using a colour scheme to represent the risk levels (green>yellow>orange>red) and focusing agency decision-making. Risks that have high probability and impact combined require most attention.

Risks identified in this framework have to be integrated with the political economy (PE) analysis. We suggest a different scale for the political economy. This is because in itself the political economy analysis does not identify risk, a concept tied to the systems and structures that may not function, but operate as compounding factor, enabling or disabling, the systems.

In the SGACA guidelines, four categories of interaction between systems and structures (formal) and the political economy are defined:

**A typology of relations between formal and informal governance<sup>2</sup>**

|   | Effective formal governance | Ineffective formal governance |
|---|-----------------------------|-------------------------------|
| Convergent objectives of informal and formal governance | Complementary               | Substitutive                  |
| Divergent objectives of informal and formal governance  | Accommodating               | Competing                     |

Source: SGACA, adapted from Helmke & Levitsky, 2004

We suggest using these categories as a basis for determining how PE impact on the formal systems and structures. Integrating assessments of systems and structures with PE can be approximated by:

$$\text{Developmental Risk (DR)} * 1/\text{Political Economy (PE)} \Rightarrow \text{final risk estimation}$$

In this simple equation, PE can be enabling or disabling with more or less impact:

1. Complementary: we suggest considering this quadrant as positive, thus lowering risk or rather increasing chances of success; translating a "functional" integration of PE and systems lowering the risks. PE value >2
2. Accommodating: is a negative impact, though limited but would not lower risk and may increase risks when systems are weak. It would require additional monitoring. The product of the integrating will always be higher than Developmental Risk but contained. PE value <1 but >0.5
3. Substituting: this is a "dysfunctional" system where the integration with PE may have a positive impact as pulling in the same direction, though not being sustainable. Developmental Risks are not heightened but the informality requires additional monitoring and control measures. PE value = 1
4. Competing/subverting: this is "disrupting" the system, in an already weak, risk prone

context. Developmental Risks are heightened. PE value < 0.5

Using this classification and equation, we can then integrate all risks with PE. We suggest a matrix where each risk is assessed and mitigation suggested. For each Developmental Risk category, we propose a summary of the overall risk.

Finally, to replicate what DfID introduced in its Fiduciary Risk Analysis and what EuropeAid refers to as the dynamic interpretation, we suggest adding a measure of change. Again such a measure can only be a crude one, based on cognitive analysis, but should be based on available information: collaboration among donors can help increasing the information. It reflects both the direction of change of systems and the dynamics read through the PE analysis.

| Direction of Change |   |
|---------------------|---|
| Positive progress   | ↑ |
| No change           | ↔ |
| Negative progress   | ↓ |

Although the direction of change does not modify the risk assessment, it contributes towards making a judgement on the quality of analysis made. This control works overtime as a control on the analysis, monitoring if risks change in response to support and to specific measures. An analysis resulting in a lower risk but with a negative direction of change would probably be inconsistent.

## 7. Risk Strategy

This paper has dealt with the questions of defining, assessing and reporting on the various levels and types of risk in the aid environment. Risk management is concerned with using that assessment to inform decisions, about the choice of aid modality, about disbursement and about the stages in the aid operation. These decisions and actions can be called the 'risk strategy', which covers the choices about risk appetite, risk avoidance, risk mitigation, risk sharing and risk transfer. The assessment does not provide automatic guidance for these decisions, it informs the necessary judgements. There is a risk that risk assessment might become a bureaucratic process. Sir John Bourne, previously the UK Comptroller and Auditor General, warned of this: *"This does not mean that 'risk management' should be turned into another bureaucratic process through which people go as a 'box ticking' exercise that allows them to escape responsibility for their actions by claiming to have followed 'proper procedures'."*<sup>13</sup> Building donor capacity to assess context, defining standards to use these assessments and present appreciations on a country system's risks and how best to deliver aid will remain the best approach.

### Risk Appetite

A definition of risk appetite was given above: 'the amount of risk that an organisation is prepared to accept, tolerate, or be exposed to at any point in time.' The first choice to be made is how much risk is acceptable in a given situation. In countries where all systems are operating smoothly the use of country systems and general budget support will present low risk. Where country systems are less reliable and present higher risks, other aid modalities will be preferred, but a project approach does not in itself present no risk. Many aid failures have occurred using project funding modality. Indeed, countries where systems work smoothly may not require financial aid but rather a narrower technical, scientific, trade, etc. cooperation.

Writing specifically about the use of aid to create a government 'turnaround', Paul Collier called for a less risk-averse approach to aid disbursement: "Aid used in this way to support incipient

<sup>13</sup> John Bourne, Chapter 9 'Risk averse or risk ignorant?' in 'Public Sector Auditing – Is It value for Money?', Chichester: Wiley, 2007, p.319

turnarounds would be pretty high-risk...The payoff is pretty high because the successes, when they happen, are enormously valuable...Without this sort of model bureaucracies just cannot cope with risk. Their staff will not take large risks because they imply periodic failure, and failure means a blighted career. Unsurprisingly, people are simply not prepared to take risks on these terms. The situation is getting worse as people are increasingly assessed in terms of the “results” they achieve. Within aid agencies there is a vogue for a results orientation, and up to a point this is sensible – senior managers are trying to get their workforce to focus on outcomes, not inputs. But a focus on results can very easily encourage people to avoid failures at all costs. And if this happens aid will increasingly be directed to the safe options of countries where performance is already satisfactory.”<sup>14</sup> This argument applies to all countries where the governance is less than completely reliable: the most need is likely to be in the places with the worst governance and therefore the highest risk of failure. Outcomes are by definition longer term than outputs, and risk strategies based on outcome indicators will be less reliable than strategies based on outputs in the short term.

Strategically, risk appetite should be related to the likely return: more risk should be acceptable in contexts where the current situation is very bad and where the likely impact of intervention is very high. To enable this strategy to be pursued, all stakeholders, including relevant EU governments, must accept the relationship between risk and return.

The first decision to be made about risk strategy is how much, and which risk can be tolerated.

### **Risk avoidance**

Where the developmental risks are very high and the likely return low, seeking an alternative aid modality to budget support may be necessary. However reducing risk exposure reduce the scale of the objectives as well. It may just be that the intervention should be rethought altogether. If there is a high probability that the financial management and implementation are so poor that the policy or programme inputs will not produce outputs, irrespective of the aid modality, either put in place high levels of oversight and accept the cost of that, or avoid risk by not funding at all or re-think intervention logic.

### **Risk sharing**

For private investors the textbook way of transferring risk is to write an insurance contract. In a way, the variable tranche in a budget support programme is analogous to an insurance policy: unless the indicators are met, disbursement does not take place. In this case risk is shared: the donor does not attain the objectives of its support operation though a fixed tranche has been disbursed, while the country does not receive the full financing. Both actors<sup>15</sup> have a common interest to share this risk and enter into policy and management dialogue to ensure a successful outcome.

The analogy with private sector is not an exact fit: in the private sector, if the principal transfers the risk to the agent and the agent fails, the agent does not get paid and another can be hired. If a donor transfers a risk to a government, by holding back a tranche of grant, the risk falls on the ultimate beneficiary who does not get the service as a result.

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<sup>14</sup> Paul Collier, ‘The Bottom Billion’, Oxford: Oxford University Press, 2007, p.117

<sup>15</sup> On the government side, the actor is typically the programme manager whose interest is to implement its programme. While budget support does not fully fund such a programme it provides the fiscal space for the line ministry to make the case for at the ministry of finance. Failing to meet targets will result in a high sanction for the manager, losing credibility within the ministry and with the ministry of finance. On the donor side, ensuring a realistic design and engaging in a close management and policy dialogue are essential risk prevention to maximise chances of success.

Policy failure risk can be shared by creating incentives for the government, and other development partners to prevent failure. If any single donor bears a very high proportion of the cost of a sector or a policy area, all the risk of failure falls on that donor. Government accountability and exposure can be increased through an increase in government contribution.

The government's commitment to a programme consists both of the commitment of resources and of reputation. If individual Ministers' reputation and therefore success depends on successful policy outcomes and impact, they are likely to be more committed to success. On the other hand, the development and encouragement of personal champions for a policy brings with it the political risk of a change of personnel at the top.

The degree of commitment can be assessed, and possibly strengthened by regular policy dialogue with those who need to be committed. A lack of commitment on the part of the partner government or ministry, with risk falling only on donors, should be a signal for risk avoidance and therefore exit.

The risk sharing can be specified in the financing agreement: although there is a broad agreement on limiting conditions in financing agreements, as in OECD governments, allocations need to reflect a service level agreement. Such an agreement might not be specifiable and monitorable in the form of results, but only using proxies as outputs and sometimes, in weaker systems, using inputs and institutional arrangements. This is because countries do not necessarily have in place public finance systems allowing policy analysis, or efficiency measurement but simpler input control systems. Specifying those contractual arrangements imply dialogue and agreements on these measures based on existing systems and their likely development. This would form the basis for monitoring and managing dialogue. Ex ante conditionalities were one way of trying to reduce risk. In the post-Accra way of working, ex post conditionalities on variable tranches are still used.

What alternatives would exist in such a scenario? It may well be that seeking partners to share the risk, outside the public sector, and reducing ambitions may be a valuable alternative to pursue. This would include working with NGOs, UN agencies, private partners, social marketers, etc. Though not a new manner of working, formally integrating the different partnership approaches existing would usefully provide guidance for practitioners.

## **Risk mitigation**

There are five main categories of risk mitigation:

1. Choice of funding modality to reflect the level of risk: where the developmental risk is deemed too high (whether residual risks or risks that cannot be reduced through mitigating measures monitorable), funding modalities that provide detailed and direct supervision and monitoring by the donor are preferred. These modalities bring additional risk in the form of fiduciary risk and transaction costs.
2. Specifying the financing agreement: although there is a broad agreement on limiting conditions in financing agreements, as in OECD governments, allocations need to reflect a service level agreement. Such an agreement might not be specifiable and monitorable in the form of results, but only using proxies as outputs and sometimes, in weaker systems, using inputs and institutional arrangements. This is because countries do not necessarily have in place public finance systems allowing policy analysis, or efficiency measurement but simpler input control systems. Specifying those contractual arrangements imply dialogue and agreements on these measures based on existing systems and their likely development. This

would form the basis for monitoring and managing dialogue. Ex ante conditionalities were one way of trying to reduce risk. In the post-Accra way of working, ex post conditionalities on variable tranches provide an incentive.

3. Management Dialogue: this is at the heart of the financing agreement. It is distinct from policy dialogue as it concerns the management of the contractual arrangements, as specified in the financing agreement. It builds on the monitoring of the implementation to ensure that the context assessment remains valid and the agreement is implemented as planned, by both party. This is the first level of dialogue, and though it concerns only the contractual relationship between the partners, it has to be a solid basis.
4. Policy dialogue<sup>16</sup>: is the next step in the risk mitigation process. In any partnership, dialogue and agreement forms the basis. When investing, associates agree to a level of risk and investment and “live” by their decisions. To a large extent, the same applies to development cooperation. For the partnership to function, the risk and design parameters have to be fully disclosed and agreed upon, forming the basis for all future dialogue on policy. Dialogue consists of both formal and informal processes. The formal aspects help documenting the processes, monitoring, measuring and reporting. The informal processes are necessary to build trust and help using leading indicators/pointers to foresee difficulties and mitigate the risk that they come to be. Allowing policy space within clearly defined support parameters initiate processes that reduce risk. Policy dialogue will include an element of reform, whether as incremental change or broader reform effort.
5. Technical co-operation: where the risks arise from technical issues, such as choice of indicators, data collection and interpretation, procurement failures, technical co-operation will reduce risk. This is a necessary transaction cost that donors need to include in their support. Note that this is for managing the support and shall not be confounded with building capacity that requires distinct support<sup>17</sup>.

### **Risk Acceptance**

When risk is deemed within the risk appetite threshold, it can be accepted. Accepting risk does not mean passively “living with it”. It is rather a manner to express that donors have to accept that a certain level of risk exists. This risk may be residual after mitigation measures have been taken. Monitoring the context and dynamics to regularly (re-)assess risk, including when accepted is the first level of mitigation. This imposes monitoring risks and measures pertaining to those risks rather than demanding new measures to be taken by the Government. This may involve entering into specific arrangements for dialogue at sector level, or across sectors when managing financial management risks. The EC has experience with simple systems audit leading to matrix of corrective measures being agreed upon and being managed through dialogue within a working group leading to significant improvements and a reduce risk for the programmes supported.

### **Application**

These methods of avoidance and mitigation apply differently to the categories of risk we have identified.

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<sup>16</sup> Specific guidance on policy dialogue has been developed by EuropeAid and is being integrated with the overall PPCM guidance

<sup>17</sup> See OECD PFM task force upcoming report on capacity development and donors’ responses

### *Financial management risks*

If the financial management risks are extremely high and there are no prospects of mitigation, country systems cannot be trusted and BS should probably be avoided. If the rewards are high, then it might be acceptable to engage in BS but recognise the relatively high cost of monitoring or settle for a sector support to the ministry (whether through a pool arrangement or a decentralised management), avoiding part of the financial management (really the cash allocation to the sector) while maintaining budget execution through country systems (commitment, accounting procurement and reporting) and “paying the price” of monitoring and control

However, project approach is not immune to financial management risks. Risks may simply be displaced, as the government takes responsibility for delivery of results as a specific programme which may reduce external scrutiny and control of the government’s programme. The way to mitigate financial management risk is to allocate more resources to monitoring and control systems, of output delivery and indicators in situations of higher risk. Higher transaction costs are a necessary burden of risk mitigation.

### *Implementation risks*

The design of the BS agreement can mitigate implementation risk. Indicators for procurement processes, for credible control systems and measurable outputs can mitigate implementation risk, both by avoiding funding poor implementation and by limiting total disbursement if implementation is not up to standard. Some of these processes are part of the financial management system and can be classified as leading to financial management risks. Others are management risks, concerned with problems of physical implementation, capacity to manage, skills in choosing and applying indicators for performance management and generally making sure that implementation happens.

In a project approach, implementation risks can be reduced by technical assistance for the design and maintenance of credible processes and by supporting reporting and control systems.

### *Policy process risk*

A prerequisite for BS is a credible policy and programme design process. A credible process should include:

1. A credible and measurable identification of the nature and scale of the policy problem to be addressed by the policy.
2. Involvement of stakeholders in all stages of the policy process.
3. Consideration of a wide range of options for choice of policy and policy instruments.
4. Evaluation of options, including stakeholder involvement in the evaluation.
5. Development of policy scenarios to follow through intended and unintended consequences.
6. Proper arrangements for policy co-ordination among all relevant agencies.
7. An implementation plan, including the roles and activities of all contributing agencies and all stakeholders.
8. A monitoring scheme, including specification of responsibilities for data collection.
9. An evaluation process.

### *Programme design risk*

Even when the policy process successfully harnesses the above elements, there may be errors in programme design that present a risk to the success of the policy. These were listed in Section 5, choice of the wrong policy instruments, inadequate attention to the distribution of outputs and inadequate volume or quantity of outputs to achieve the outcomes.

The risks to outcomes and impact presented by poor programme and policy processes can be mitigated by targeted and relevant policy dialogue at programme and policy formulation stages.

In a project approach, risk can be mitigated by intelligent integration of projects with the overall policy and programme design, only choosing relevant projects and supporting good programme design through policy dialogue.

If the policy process and/or the programme design are inadequate for the desired outcomes and impacts, then one option to reduce risk of failure would be to change the objectives, to a more credible if less ambitious aspiration. Governments, donors and other stakeholders have an interest in very ambitious targets, especially when reaching towards MDGs. Over-claiming of the possibilities of achievement can be damaging to policies, especially when monitoring and evaluation start to detail shortfalls.

### *Political risks and external shocks*

The risk to the whole policy area from a change of government can be mitigated by developing strong links with NSAs and stakeholders with an interest in the policy, to maintain pressure on the new government to continue the policy as funded. Other risks as fiscal shocks as after elections or external shocks can only be addressed specifically. Donors cannot control the government machinery and are left vulnerable to such situations. Keeping the objectives in perspective helps maintaining dialogue, but pursuing cooperation in such situations opens up donors' flanks to reputational risks. Dialogue builds trust, the cement for cooperation. However, financing agreements are contractual arrangements that require demonstrating performance. Sharing risk between partners as done by the EC with fixed and variable tranches appears to be consistent with this risk management framework.

### **Matrix**

The matrix 'risk analysis and strategy' sets out the categories of risk and the possible strategies. The first columns of the analysis apply a standard probability and impact scoring, which should be assessed using a scale from 1 to 4. The third column is the product of these two levels and can be used to highlight those risk factors that are likely to be critical. This integration may be done using two methods:

- 1- a product, assigning a value of 1 to 4. The product will be classified according to a proportional scale: less than 2 = low, >2 and <4 = moderate, >4 and <6 = substantial, >6 high.
- 2- alternatively, first assigning systematically the higher risk level of the two measure, impact and likelihood, and decreasing it only after testing for pertinence.

Ideally both methods should be used, first to evaluate the product and second to test the pertinence.

For those that are critical, the next column is then used to indicate which risks can be accepted, or tolerated.

For those that cannot be tolerated, the rest of the matrix organises the decisions about what the strategy should be, from the choice of aid modality to specific measures integrated into the financing agreement, their monitoring and the policy dialogue.

**Example: Health Care for the bottom 10%, Sigilla, 2008**

The use of the matrix can be illustrated by example. Imagine a sector programme to improve the health status of the poorest 10% in a particular state. A sector budget support is proposed, with participation from four donors in total, with the state government and national ministry of health as the two main development partners, with some participation from the municipalities in the area of public health. A health strategy and programme are developed and an assessment is required about whether to offer sector budget support.

Each of the risks in the matrix can be assessed. Assume, first that a PEFA report is available and that the overall financial management system demonstrates an improving trend. The next element to assess would be the financial management arrangements, within the health ministry, the state government and the municipalities and in the arrangements for transfer of funds down the hierarchy of governments (peripheral service delivery). Each of the heading under financial management risks would be checked, and some will probably be given a high score for probability and impact. The factors with a high score would then go forward for actions under the risk strategy. Assume that one problem area is 'failure of linking procurement plans and commitment control', so that, up to now, even when funds have been allocated for a purpose, as the budget year progresses, funds are actually spent on items not in the budget and funds are not available for the proposed programme. Spending centres have to acquire goods, thus getting into arrears. The options are set out in the table: the risk can be avoided by not funding the sector through BS, they can be shared by making disbursements only if commitment control is improved during the period of the funding agreement, they can be mitigated by providing help with the development of a better commitment control system.

Other potential risks occur in the implementation risk category. Assume that there is inadequate capacity in the municipalities to fulfil their part of the public health programme, based on experience to date. Experience in the field suggests that municipalities are concerned with other priorities than primary health care.

Risk strategy can include avoidance: do not rely on the municipalities, but find another way of delivering that part of the policy through partners; and mitigation, by using some of the funding to develop the municipalities' capacity, requiring possibly a redesign of the policy, through the policy dialogue, to take account of the capacity problem.

Or, the indicators proposed may not be the best set to track progress. Perhaps a set of high level outcome indicators, of morbidity and mortality are preferred, given the outcome-orientation of the donors. In the short term, some output indicators might be more appropriate, to monitor whether the various policy instruments are in place. Currently, the emphasis is only on outcome indicators.

At the level of programme design, the mix of policy instruments might not be right for the desired outcomes. The balance, for example, between public health and illness treatment may be skewed towards the provision of clinics and medical staff, rather than water and sanitation and disease prevention. If these risks are highly probable and highly detrimental, the risk strategy would probably rest in mitigation: engaging in the policy dialogue to better match the policy instruments with the proclaimed outcomes. Relying on country's institutions knowledge and specialist agencies is

necessary, but it is likely that a process of redesign is necessary to move the choice of instruments. This may require a reduction in the power of medical practitioners in the process.

At a higher level, that of the policy process, the risks might lie in the likely impact of the policy on the society. Perhaps the choice of types of illness treatment intervention is such that certain categories of the population are missed out by the policy: here, a fuller engagement of all the relevant stakeholders, including those with low power and voice, might make the policy process more successful in reaching effective policy conclusions. In addition, good data collection and presentation on the impact of policy will be necessary.

Political risk includes the possibility of imminent changes to the personnel in government: ruling party changes through elections or ministerial redistributions may remove a 'champion' from the policy arena. Policies can be at risk from being identified with an individual or a faction. This risk may be avoided by ensuring that the policy process is inclusive, that commitment from a wide range of stakeholders is achieved and therefore the vulnerability to change of individuals is reduced. The political economy analysis should reveal this type of political risk.

What this hypothetical example illustrates is:

- a checklist of risks, on the left side of the matrix, is helpful in identifying what to look for in potential risks in a support programme
- not all of the risks will be present or important in any particular case but their pertinence has to be tested, primarily through the team work in the agency and possibly within the donor forums or Sector Working Groups
- different individual risks require different treatments, in deciding on aid modality, on specifications of the financing agreement, on capacity development, on monitoring and monitoring data
- risk mitigation is one of the main objectives of management and policy dialogue
- while a scoring system can help identify the most relevant risks, risk strategy requires judgment and choice, best served by collegial work
- not all risks will be apparent at the beginning of the process.

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