

Who Cares About Development Risk?

I. DEFINING KEY RISKS

Development risk is the risk that development assistance or government/agency resources will not achieve results – particularly development objectives and long term goals like economic growth and poverty reduction, and enabling objectives such as reform and capacity development. Development risk is influenced by the level of administrative burden placed on governments/agencies by donors, as well as compliance costs associated with complex donor procedures that don't match technical capacities of individuals and institutions. There is a position that capacity development and reform can be better supported by appropriate use of various country system components. The idea is based on the “use to improve” principle – in other words to improve a system you should use the system, and do not bypass or fragment it. Perceptions of development risk can be influenced by expert opinion or an evidence-based quantification of development risk. Development risk is closely related to project risk, which is the risk of failure of achieving project objectives.

Fiduciary risk is the risk that aid or government funds: i) are used for unauthorized purposes; ii) do not achieve value for money; or iii) are not properly accounted for. The realization of fiduciary risk can be due to a variety of factors, including: lack of capacity; inappropriate procedures and systems; weak competencies or knowledge; bureaucratic inefficiency; active corruption; and or weak or absent laws and enforcement. Perceptions of fiduciary risk can be influenced by expert opinion or an evidence-based quantification of fiduciary risk.

Sovereign financial risk is the risk that a loan will not be repaid in full or on time. It is a lending risk and is assessed differently through fiscal and debt sustainability analysis and other tools. Credit rating agencies constantly form and modify opinions on a government's credit worthiness based on evidence (e.g. IMF reports, World Bank reviews and publications, and government economic and fiscal reports), media reports, and information gained through their network of sources and their own analysis. Higher assessed risks by these agencies may result in an increase in the cost of borrowing for the country, the extent to which is subject to other factors, including market reactions.

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Reputation risk is the risk that perceptions of poor management of funds or poor levels of development effectiveness (whether real or otherwise) will have adverse consequences. Reputation risk applies to donors, governments, and agencies. In terms of donors, adverse consequences include: i) deterioration in the level of support for foreign aid by tax payers, central agencies, members of parliament, development ministers and cabinet; ii) criticism of aid management; and iii) deterioration in diplomatic relations with a partner country and international finance institutions. In terms of country governments, reputation risk is relevant as they are ultimately accountable to their citizens for the efficient and effective use of all national resources. Reputation risk can influence sovereign risk and perceptions of fiduciary and development risk. For agencies, adverse consequences include loss of management control and additional administrative burdens arising from heightened external scrutiny and criticisms at multiple levels.

Political Risk (or geopolitical risk) generally refers to difficulties agencies, firms and/or governments may face as a result of political decisions or “any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.”¹ Political risks are hard to quantify due limited sample sizes or case studies when discussing an individual nation, though certain risk rating agencies attempt this.

II. THE STOCK-STANDARD FIDUCIARY RISK ASSESSMENT

Fiduciary risk assessments are done on governments by donors, while development risk assessments are done by governments for themselves. Bilateral donors tend to be afraid of the consequences of corruption when aid money is involved. This has arguably more to do with reputation risk rather than fiduciary risk, since aid policy can be seen as a political process rather than an altruistic effort to reduce poverty. The financial and non-financial costs of a reputationally risky event happening may be significantly different. For example, corruption reported in the press from mispending a small amount of donor funds may have far

worse political fallout than getting low value for money from a high cost technical assistance program that delivers little in reality.

These reputation risk realities cause problems as aid agencies try to protect themselves and their ministers and/or boards. Consequences include serious fragmentation of government systems and establishment of project cultures within aid dependent governments. Such consequences then lead the system to reflect higher overall fiduciary risks, as fragmented accountability systems are more easily exploited.

A general view appears to be that development and fiduciary risks are “two sides of the same coin and cannot be usefully be separated”. This DPN argues that they are different, and that focusing on development risk and recognizing the trade-offs between development and fiduciary risk can result in far more cost-effective aid. In two countries where this was done, a key result was that it enabled adoption of development assistance policies that promote the use of country systems in order to improve country systems, while also increasing the accountabilities of aid recipients to deliver real results on time and to standard. The use of performance-linked sector budget support mechanisms that target reductions in fiduciary and development risks is the gold standard to deliver on this approach – when the conditions are right.

III. HOW IS DEVELOPMENT AND FIDUCIARY RISK QUANTIFIED?

The approach taken to quantify development and fiduciary risks is based on a standard risk quantification methodology. The approach has been used in various settings, including Papua New Guinea, Iraq & Afghanistan, Turks and Caicos Islands, Tokelau, Sri Lanka, Liberia, UNRWA (including West Bank and Gaza, Syria and Jordan) and Timor-Leste. The approach uses a standard risk quantification approach of: performance score multiplied by risk factor, where risk factors are associated with the system generally - not the country context (see the box below).



$$\text{Risk Score} = \text{Score for System Performance} \times \text{Risk Factor}$$

(Fiduciary or Development)

The methodology for the quantification of development and fiduciary risks is based on approaches developed by the UK, EU, and World Bank that focus on performance indicator scores provided under the Public Expenditure and Financial Accountability (PEFA) framework. Additional performance measures are also added to enable deeper analysis and include: i) indicators for sub-national governments, ii) indicators drawn from a sector Public Financial Management (PFM) assessment framework that is based on the PEFA framework; and iii) gender indicators derived from UNIFEM work on gender responsive budget initiatives.

Quantifying development and fiduciary risk is open to criticism that it establishes a false sense of understanding of the future, and thereby control.

However, quantifying risk should be seen as framework to guide practitioners through a highly subjective area that often determines the way aid is delivered in a country – e.g. often resulting in the avoidance in the use of country systems and entrenching fragmentation of those systems.

Public finance risk factors, by definition, are stable over time and over different country or institutional contexts.

This helps to complete a risk assessment quickly once a PEFA assessment is complete. Moreover, it facilitates inter-country, inter-agency and inter-temporal comparisons.

Fiduciary risk is more closely aligned to the actual financial flows or expenses incurred and the recognized importance of what is termed “ex-ante financial controls”, which are basically just checks prior to authorizing a transaction. It is much more closely aligned with corruption risk. Relatively higher fiduciary risk factors are therefore assigned to those PEFA dimensions that closely align to actual expenses and controls. A moderate factor is assigned to elements that align more closely with expense monitoring or classification (to capture intended purpose) while the lowest fiduciary risk factor is assigned to policy based budgeting.

Development risk can be thought of as more long term in nature. It is closely aligned with how budgets are put together as these are the fiscal policies that are supposed to help achieve long-term development objectives - such as the pursuit of the Sustainable Development Goals (SDGs) and poverty reduction. Fiduciary risk can be thought of as more short-term in nature (e.g., to ensure actual flows are

adequately accounted and controlled to minimize the risk that resources go to unauthorized purposes). Hence high development risk factors are applied to systems that support medium term budgeting, fiscal learning and continuous improvement.

The risk quantification approach is designed to quantify systemic development and fiduciary risks. Under the framework functional capacities as assessed under PEFA are grouped according to their risk contribution to the following key PFM sub-systems: i) Parliamentary System for Approval and Scrutiny; ii) Planning and Budget Systems; iii) Treasury Disbursement System; iv) Accounting, Recording and Reporting System; v) Payroll System; vi) Non-Salary Expenditure Control System; vii) Procurement System; viii) Debt Management System; ix) Taxation System x) Non-Tax Revenue System; and xi) Audit System.

IV. SCORING

Each PEFA indicator is assigned a fiduciary risk factor and a different development risk factor if considered materially different. The risk mitigation score, which is used for prioritization, is a multiplication of the indicator performance score by the risk factor. Risk factors are assigned the following numerical equivalents: High = 3, Moderate = 2, and Low = 1. The PEFA dimension scores are translated to following numerical equivalents: A=1, B=2, C=3 and D=4, with summary indicator scores containing a “+” having the corresponding numerical score reduced by 0.5. If considered materially different, fiduciary factors were adjusted based on time-wise and other related trade-offs associated with development benefits and fiduciary risks. Resulting risk scores are assigned the following descriptive scores: Very High = 11-12, High = 8.5-10.5, Moderate = 5-7.5, Low = 2.5-4.5 and Very Low = 1-2. The approach can be applied to the original or revised PEFA frameworks.

V. USE OF FIDUCIARY AND DEVELOPMENT RISK SCORES

Inherent fiduciary and development risk scores can be used to help prioritize reform efforts. Such assessments can help direct reform option dialogue around highest risks. The current approach supports dialogue by helping donors and government officials speak the same technical language. This benefit comes from the fact that the risk assessment approach is founded on PEFA framework. It should be

noted that reform programming needs to take into account political and technical feasibility of achieving PFM reform objectives.

So who cares about the development risks when working with government systems?

While there is plenty of rhetoric about aid effectiveness the real answer is that we don't know - yet. But two governments have already undertaken development and fiduciary risk assessments to inform their own reform planning and aid policy frameworks. These countries are Afghanistan and Timor-Leste. The donors that supported these governments in this area are Australia, the European Union in both countries, and in Afghanistan, the UK, U.S. and World Bank. Both Timor-Leste and Afghanistan have undertaken relative risk assessments. These compared fiduciary risks posed by project-based and in-kind forms of development assistance with the inherent systemic risks posed by using country systems. Results indicate

that project-based systems that bypass country systems unambiguously increase development risk, but are not significantly better at reducing exposure to fiduciary risks. The next few years will reveal if donors start to take development risk much more seriously in a new global effort to help country systems become stronger, sustainable and much more cost-effective.

Examples of graphical representation of fiduciary and development risks using this methodology are provided in the figures below.

Andrew Laing, June 2016

References:

1. DiPiazza and Bremmer, 2006, "*Integrating Political Risk Into Enterprise Risk Management*", Pricewaterhouse Coopers and Eurasia Group, New York, USA

FIGURE 1

ILLUSTRATION OF DEVELOPMENT RISK – AN EXAMPLE: PEFA

DEVELOPMENT RISKS BY PEFA FUNCTION

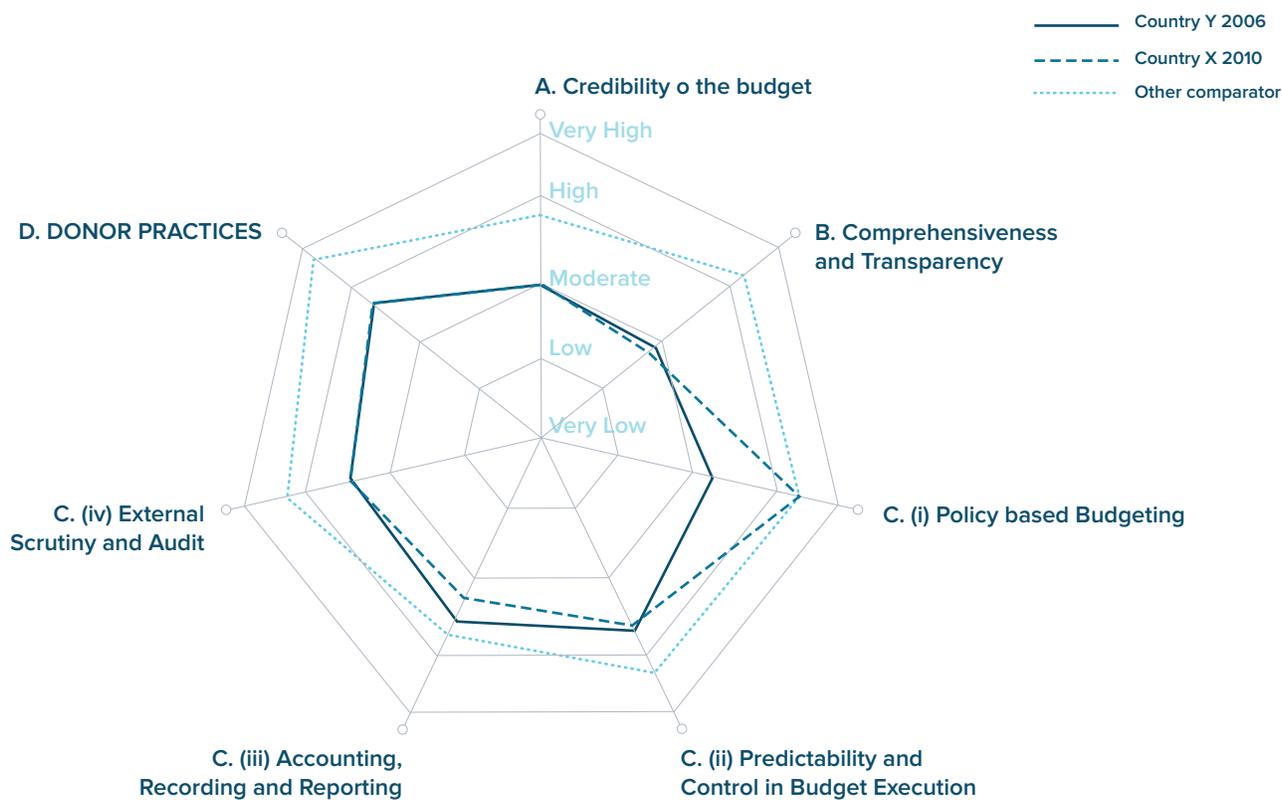


FIGURE 2

ILLUSTRATION OF FIDUCIARY RISK – AN EXAMPLE: PEFA GROUPING

FIDUCIARY RISKS BY PEFA FUNCTION

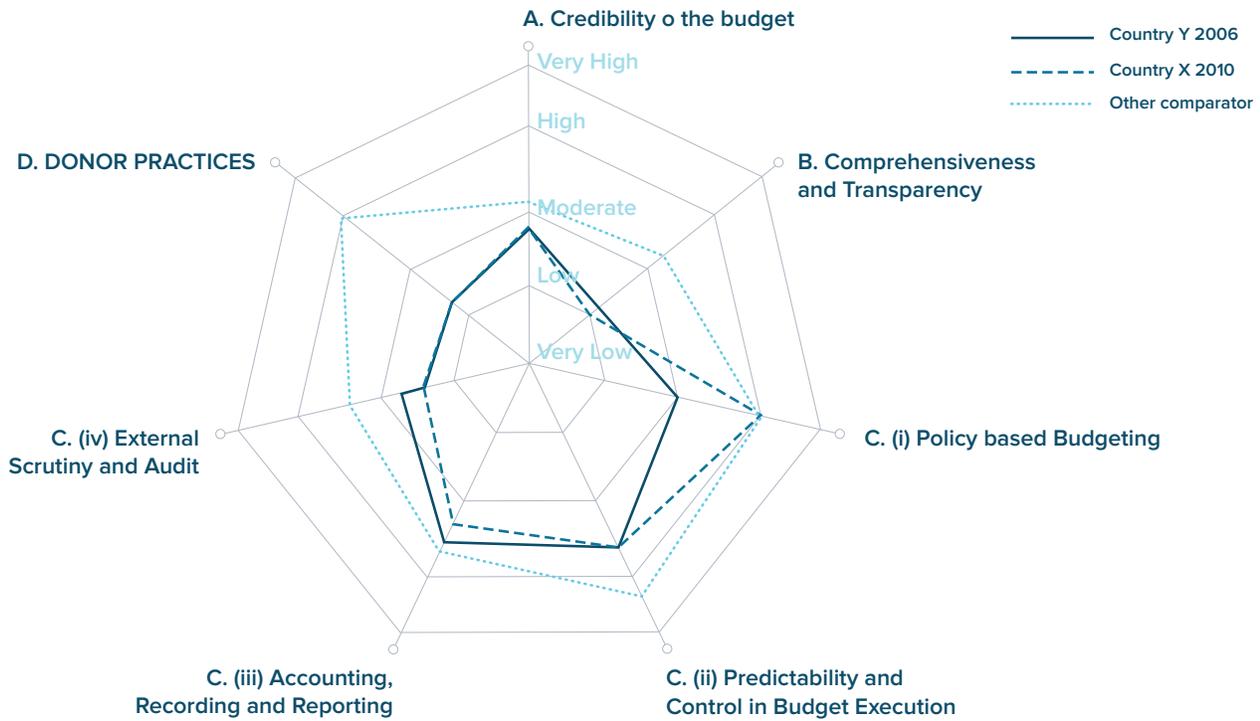


FIGURE 3

ILLUSTRATION OF DEVELOPMENT RISK – AN EXAMPLE: PEFA GROUPING

DEVELOPMENT RISKS BY PEFA FUNCTION

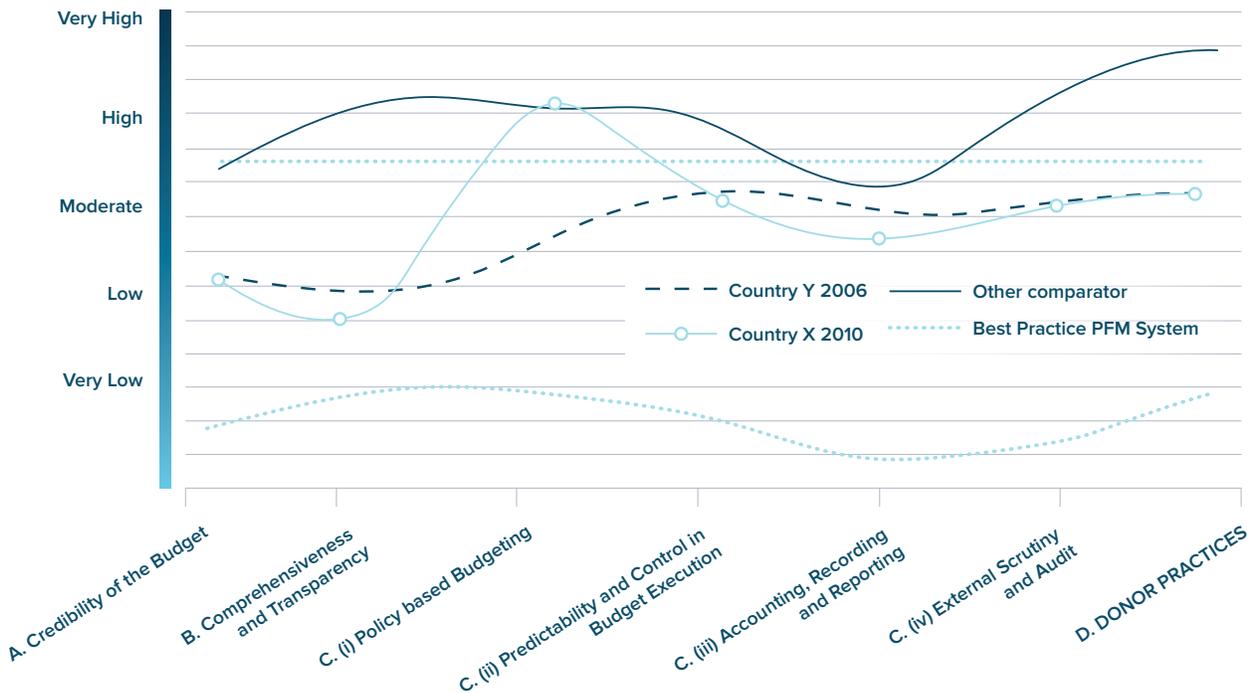


FIGURE 4 ILLUSTRATION OF FIDUCIARY RISK – AN EXAMPLE: PEFA GROUPING

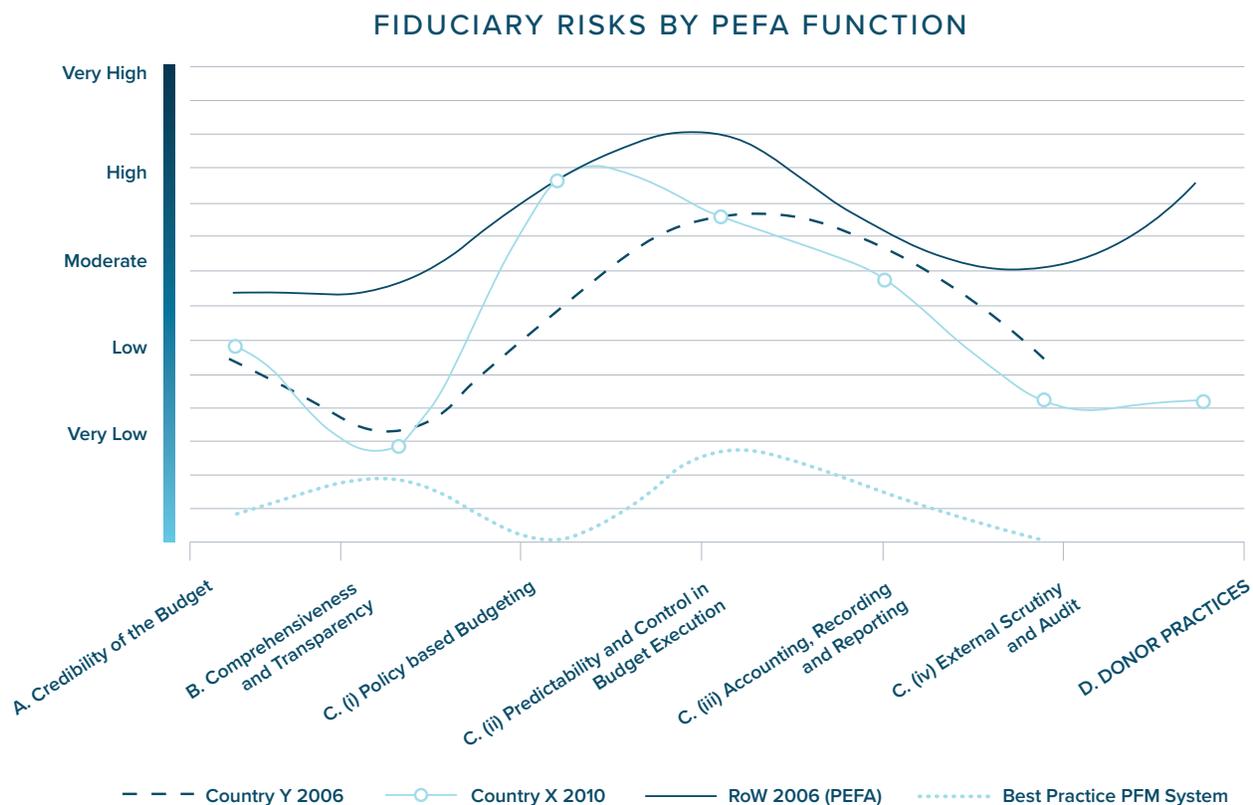


FIGURE 5 ILLUSTRATION OF FIDUCIARY AND DEVELOPMENT RISK – AN EXAMPLE: PFM SUB-SYSTEM

