Conflict and Fragility

Managing Risks in Fragile and Transitional Contexts

THE PRICE OF SUCCESS?

OECD

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Foreword

From the anarchy of Somalia to the relative stability of Nepal, fragile and transitional situations represent a broad spectrum of contexts. However, they share some common features: these are risky environments – for the people who live there, for their governments, for neighbouring countries, and for those who seek to provide assistance. Positive outcomes are hard to achieve, and the risk of regression in countries emerging from armed conflict is high.

International engagement in these situations presents significant risks for donors and implementing partners, but also holds the potential for substantial rewards in terms of improved results and outcomes. Aid plays an important role in these situations, not least because it offers one of the few available means for positively influencing peacebuilding and statebuilding processes through providing critical humanitarian and development aid.

Indeed, more often than not, the risks associated with not engaging in these contexts – both for the countries themselves and for the international community – outweigh most of the risks of engaging in the first place. The question therefore is not *whether* to engage but *how* to engage in ways that are context-specific and do not come at an unacceptable cost.

As this publication shows, current approaches to risk management hamper the delivery of positive outcomes. Current attitudes to risks reflect competing demands across aid and political spheres for impact and quick results on the ground – necessary to keep the momentum of peacebuilding and statebuilding processes – and accountability and reporting requirements. Meanwhile, standard aid procedures are often too slow and inflexible, reflecting a generally risk-averse aid culture.

Appropriate risk-taking is essential to effective engagement in fragile and transitional situations to deliver longer-term, transformational results. Exposure to corruption and fiduciary risk is an inevitable part of engagement in fragile states – but that does not mean that it has to be tolerated or that it cannot be managed. Taking appropriate risks requires political backing, the right incentive structures, sufficient staff capacity and appropriate institutional processes and control measures. It also means striking a balance

between risk and opportunity, and taking advantage of sometimes narrow windows of opportunity. Most importantly, it needs collective action and approaches to risk management across the international community, a better balance of high- and low-risk engagement and more realistic mutual expectations between donor governments and their implementing partners.

This publication provides the evidence to help donors understand how to protect their institutions while delivering better results to those who need it most.

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The study draws on interviews and consultations with selected INCAF members and international organisations, including: Australia, Canada, Denmark, the European Commission, Germany, the Netherlands, Sweden, the United Kingdom and the United States, as well as the IMF, the Millennium Challenge Corporation, UNDG, UNDP/BCPR, UNDP/MDTF Office, UNICEF, UNOCHA, the UN Peacebuilding Support Office, WFP and the World Bank.

The development of this report has benefitted from an independent expert group consisting of Dan Alamariu (The Eurasia Group), Anton Baaré (NCG Denmark), Claudia Burkin (KfW), Nicholas Crawford (WFP), Corene Crossin (Control Risks), Wes G. Darou (Canadian International Development Agency), Jack A. Goldstone (George Mason University), Nick Grono (International Crisis Group), Faris Hadad-Zervos and Stephen Ndegwa (World Bank), Clare Lockhart (Institute for State Effectiveness), Phil Vernon (International Alert), and Catherine Woollard (European Peacebuilding Liaison Office). The findings and conclusions have also benefitted from regular feedback and suggestions from members of the INCAF Financing and Aid Architecture Task Team and were discussed and amended following an international conference on risk management in Brussels in June 2010. The findings and conclusions have also benefitted from input during a

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Table of contents

Acronyms 11

Preface 13

Executive summary 15

***Chapter 1.* Aid, risk and state fragility** 21

What risks are involved? A new typology 25
Concepts and definitions: fragility, transition, risk 28
International principles, agendas and frameworks 34
Tensions and contradictions 37

***Chapter 2.* Risk perceptions and analysis** 43

2.1. Risk in development and humanitarian policies 45
2.2. How do donors assess and report risk? 46
2.3. Bridging differences in risk perceptions and tolerance 54

***Chapter 3.* Approaches to managing risk in fragile states** 67

3.1 Institutional approaches to risk management 68
3.2. Financing in risky settings 74
3.3. Technical assistance 83

***Chapter 4.* Ways forward: taking appropriate risks** 85

4.1. Risk management: lessons from other sectors 86
4.2. Understanding corruption and the risks it presents 91
4.3. Local procurement: risk and opportunity[19] 106

***Chapter 5.* Conclusions and recommendations** 117

References 125

Annex A. **Bases of risk analysis** 131

Annex B. **Some policy dilemmas of intervention in fragile contexts** 133

Annex C. **A typology of corruption-related risks** 137

Annex D. **List of interviews** 139

Annex E. **Conclusions and proposed next steps: "Risk and Results Management in Development Cooperation: Towards a Common Approach". Copenhagen 26 November 2010** . . . 145

Annex F. **Terms of reference: Framing Paper on Risks and Risk Management Strategies Associated with the Delivery of International Aid to Fragile and Conflict-Affected Countries** 151

Figures

Figure 4.1 How much of the UN's DPKO operating budget enters host economies? 108

Figure 5.1 The highly concentrated nature of aid to fragile states, 2008 119

Table

Table 4.1 Managing procurement risk 111

Boxes

Box 1.1 Categories of risk 24

Box 1.2 Non-state providers in violent contexts 27

Box 1.3 Risk terminology 31

Box 1.4 What can we influence? 33

Box 1.5 Principles for donors 35

Box 2.1 The UK's Programme Risk Assessment Matrix 47

Box 2.2 Sida's risk assessment in the Democratic Republic of the Congo 50
Box 2.3 Somalia and the problems of aid monitoring in highly insecure environments 53
Box 2.4 Shared risk analysis: a US example 55
Box 2.5 System-wide cultures 58
Box 2.6 Risk psychology and individuals' risk behaviour 60
Box 3.1 Joint UN risk management approach in Somalia 69
Box 3.2 DFID's approach to risk management in Nepal 70
Box 3.3 New rules of engagement: the US Office of Transition Initiatives 71
Box 3.4 How DFID balances aid risks in the DRC 74
Box 3.5 Pooled funds, fiduciary risk and the limits of effectiveness 80
Box 3.6 Donor experiences with expert rosters 84
Box 4.1 Enterprise risk management 89
Box 4.2 Human-made risks and risk governance 90
Box 4.3 What is corruption? A typology 92
Box 4.4 Accounting for funds in Iraq 93
Box 4.5 Follow the money: the case of Uganda's education system 95
Box 4.6 Corruption risks in the aid chain: the case of Somalia 104
Box 4.7 What is procurement and what risks does it raise? 107
Box 4.8 Balancing risk and opportunity 112
Box 4.9 WFP and the Haiti earthquake 113
Box A.1 Risk and uncertainty 131

Acronyms

BMZ	German Federal Ministry for Economic Co-operation and Development
CAF	Country Assessment Framework
DAC	Development Assistance Committee
DANIDA	Danish International Development Agency
DDR	Disarmament, demobilisation and reintegration
DFID	Department for International Development
DoD	Department of Defense
DRC	Democratic Republic of the Congo
ERM	Enterprise risk management
EU	European Union
FSP	Principles for Good International Engagement in Fragile States and Situations
GHD	Good Humanitarian Donorship
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH
IDA	International Development Association
IMF	International Monetary Fund
INCAF	International Network on Conflict and Fragility
MDG	Millennium Development Goal
MDTF	Multi-Donor Trust Fund
MDTF-SS	Multi-Donor Trust Fund Southern Sudan
MENAD	Middle East and North Africa Department

M&E	Monitoring and evaluation
MFA	Ministry of Foreign Affairs
NGO	Non-governmental organisation
NORAD	Norwegian Agency for Development Co-operation
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OPCFC	Fragile and Conflict-Affected Countries Group
OTI	Office of Transition Initiatives
PD	Paris Declaration on Aid Effectiveness
PDT	Peace Dividend Trust
PFM	Public financial management
PJF	Programme-oriented joint financing
PRAM	Programme Risk Assessment Matrix
P4P	Purchase for Progress
RC	Resident Co-ordinator
RMO	Risk Management Office
Sida	Swedish International Development Co-operation Agency
SIGIR	Special Inspector-General for Iraq Reconstruction
SPF	State and Peacebuilding Fund
SSR	Security sector reform
START	Stabilisation and Reconstruction Task Force
UK	United Kingdom
UN	United Nations
UN DOCO	UN Development Operations Co-ordination Office
UNDP	UN Development Programme
US	United States
USAID	US Agency for International Development
WFP	World Food Programme

Preface

This study, commissioned by the Organisation for Economic Co-operation and Development's (OECD) International Network on Conflict and Fragility (INCAF) Task Team on Financing and Aid Architecture, deals with a topic that has become an increasing priority for many aid actors. In the words of the UN Secretary-General in his report on *Peacebuilding in the Immediate Aftermath of Conflict*, "I look forward to an early outcome from the ongoing efforts of the [OECD DAC] to revise donor procedures so as to allow earlier and faster release of funds in post-conflict situations with a higher tolerance of risk … I urge donors to be bold and innovative in finding solutions that will establish flexible, rapid and predictable funding modalities for countries emerging from conflict." (UN, 2009).

Our subject is "aid risks" – and while much of the report deals with funding and fiduciary issues, we have looked more broadly at the risks associated with engagement (and failure to engage) in fragile and transitional contexts, the way in which these risks are managed, and the balance struck between risk reduction and risk taking. The research contributing to this report was mostly conducted during 2010, and included interviews with donor and UN staff at headquarters level, and a review of documentation (policy, procedures, evaluations) and relevant literature (see Annex D).

The purpose of the report is four-fold: *(1)* to set out a coherent conceptual and analytical basis for discussions around this topic; *(2)* to provide an overview of current donor approaches to risk (Chapter 2-4 set this out in some detail); *(3)* to assess the strengths and weaknesses of current policy and practice in the context of fragile states and transitions, looking at evidence of good practice within the aid sector and beyond; and *(4)* to draw conclusions and recommendations for OECD Development Assistance Committee (DAC) donors. Three important caveats should be noted here. First, we have reviewed approaches to risk and risk management primarily as seen through the eyes of donor government staff in headquarters, and through the lens of institutional procedures and policies. This does not necessarily reflect practice throughout an organisation, particularly at the field and programme implementation level. This practice depends in part on the way in which

policy is understood and implemented and the extent of discretion given to regional and country offices, or to implementing partners.

Second, we have been able to give only limited attention to risk and risk management as understood and practised by programme implementing agencies, the United Nations (UN) and non-governmental organisations (NGOs). This is a significant limitation, not least because the dominant risk culture in the sector is shaped in part by mutual expectations and understanding between these agencies and official donors. One particular feature of this culture that has shown a marked shift in recent years concerns the safety of field staff in insecure environments. Here the UN in particular has shown a markedly more risk-averse (though arguably more professional) approach to operational security management since the traumatic Baghdad bombings of 2003. This has obvious knock-on implications: if donors are dependent on international agencies to deliver programmes, then both their "reach" and their ability to account are effectively limited by agency security policy – and ultimately, of course, by the nature of the operating environment. We consider this issue in the report in relation to the extreme case of Somalia.

The third, perhaps most important, caveat concerns aid recipient countries' perception of risk. Given the limits of the study, we have not been able to consider risk either through the eyes of the governments in question or the population at large. Clearly, this is an essential matter for consideration: national and international perspectives on risk may be very different and in particular countries, differing priorities often lead to different perceptions of risk.

It should be noted that the report provides an overview of approaches from a strategic and policy perspective rather than a technical perspective. Those looking for detailed technical prescriptions on operational risk management will not find them here. We have only considered the more technical elements of risk management where necessary for the wider analysis, and clearly there is a great deal more to be said about good risk management practice than is reflected in this report. That said, some detailed analysis on specific topics (such as corruption and procurement) will be found in the body of the report and are dealt with more fully in accompanying papers referenced in the text.

A short form of this report is available on the INCAF website.

Executive summary

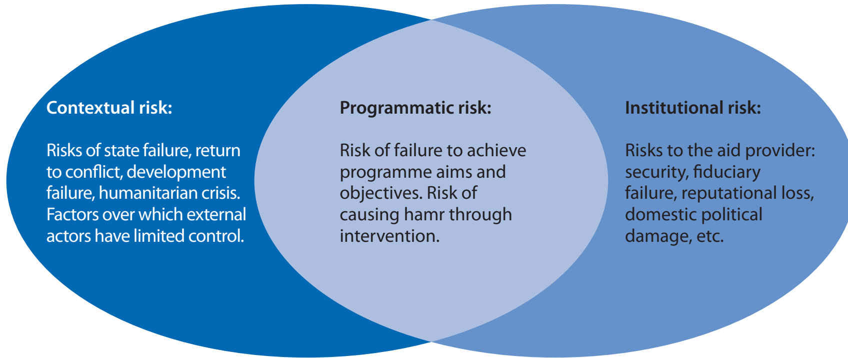
Should aid providers be more willing to take risks when working in fragile states? This is the question investigated by this report. Taking as its starting point the suggestion that donors may be too risk averse in their aid engagement in these contexts, the study considers the evidence for this and related propositions. Based on an analysis of donor policy, it makes recommendations for change in approaches to risk that might lead to greater aid effectiveness in these environments. The study, commissioned by the OECD DAC's INCAF Task Team on Financing and Aid Architecture, reviews approaches to risk and risk management by aid providers (principally bilateral and multilateral donors) in fragile and transitional contexts. It draws on interviews with selected DAC members, together with some of their key partners in the UN and World Bank systems, as well as literature and evidence of risk management practice in other sectors, public and private.

The topic of risk management is of growing significance for international foreign policy, particularly in light of the convergence of development, security, peacebuilding, statebuilding and related agendas in post-conflict and transitional contexts. Approaches to risk in these contexts have to consider multiple factors and potential outcomes, including the risks of not intervening. On the overall question of risk aversion, the report concludes that while donors have shown considerable risk appetite in funding programmes in highly volatile and insecure contexts like Afghanistan and Iraq, aid effectiveness in many transitional contexts like South Sudan is hampered by risk-averse processes that are slow and inflexible – often when speed and flexibility are required to achieve the desired results.

Current attitudes to aid risks reflect competing demands on the aid system. On the one hand, expectations have grown surrounding the impact of aid on the "meta-agendas" (peacebuilding, etc.) outlined above. On the other hand, reporting and accountability controls have tightened to the point where flexibility and innovation are in danger of being lost. In these high-risk environments, standard operating procedures do not work well. The report argues for a more differentiated approach to risk management in these contexts.

A new framework for understanding risk

The study starts by proposing a conceptual framework for aid risk analysis. This distinguishes between *contextual*, *programmatic* and *institutional* risk, and the links between them:



Within these three categories, different types of risk (political, fiduciary, etc.) are further defined, and a distinction drawn between risk *outcomes* and risk *factors* – often confused in practice. We propose that DAC donors adopt this basic framework to facilitate collaboration and provide a common basis for discussion across different donors' own risk management frameworks.

Risk management: striking a balance

Risk management is not just about risk reduction: it involves balancing risk and opportunity, or one set of risks against another. Since the strategic aims of aid in fragile states relate largely to the reduction of contextual risks, it is against these that aid risks must be balanced and justified. Broadly speaking, the higher the perceived contextual risk, the greater may be the willingness to run higher than normal levels of institutional and programmatic risk. Low institutional risk may come at the cost not just of programmatic risk but of strategic failure. But a balance must be struck: how to ensure adequate confidence that aid is well used without imposing stifling controls and conditions?

The current aid effectiveness agenda entails a strong focus on both *national ownership* and on *accountability*. With regard to national ownership, a balance must again be struck between the risk of delegating responsibility to weak institutions too early, and the risk that those institutions will fail to develop in part

because they are bypassed by aid interventions. With regard to accountability, the pressure to demonstrate results has to be weighed against the flexibility and the "willingness to fail" that these environments seem to demand. We believe the solution lies partly in greater honesty and transparency about exposure to risk between donors and those they fund; and greater realism in conversations between managers and financial controllers about the parameters within which these aid interventions can realistically be conducted and accounted for.

Donor approaches to risk

While many donors recognise the policy tensions identified above, their responses differ. Some acknowledge that the normal rules need to be interpreted with a degree of latitude in fragile settings. Some rely heavily on humanitarian mechanisms which are better adapted to such demands, but which are restricted in what they can achieve. A few have established specific financial and programme mechanisms for engaging in such contexts (generally under a "stabilisation" rubric) that allow for much greater flexibility, speed of decision-making and devolution of control. But these currently account for only a small fraction of the aid funds allocated to these contexts.

Increasing pressure to account for the use of public funds and a growing intolerance of corruption have led to a particular aversion to fiduciary risk among development actors. Donor policy is highly risk averse when it comes to corruption, but donors need to accept that they will be more exposed to such risks in these contexts and adapt their control measures accordingly. Accepting heightened exposure to corruption does not imply accepting corruption itself.

The perceived risks associated with typical development funding approaches – general budget support in particular – are judged by most to be too high in fragile contexts. Concerns about corruption, weak governance, lack of absorptive capacity and the political risks associated with transitional regimes lead most donors to choose other channels, preferring to fund projects and programmes implemented by trusted UN, NGO or commercial partners. This preference for project aid can be seen as a risk management approach, involving both retention of a degree of control by donors and a transfer of aid risk to the implementing agency concerned. The study found that donors and their implementing partners have quite different perspectives on risk sharing. Implementing agencies tend to feel that donors simply "dump" risks on them. When problems arise, the agency is held publicly accountable – and so bears a high degree of reputational risk.

In recent years, new forms of risk transfer and risk sharing have involved the pooling of donor contributions in designated funds. The preferred pooled funding model in transitional contexts – the multi-donor trust fund (MDTF) – is seen as one way of overcoming the problems of bilateral budget

support and a way of sharing risk, but it has proved problematic in practice. This again appears to be partly a result of irreconcilable expectations. Fund managers are expected *both* to provide watertight fiduciary guarantees *and* to be able to disburse large amounts in relatively short time frames in the absence of the normal assurances on the part of those they are funding. Adapted models involving separate UN and World Bank funding "windows" with different risk parameters (as used in Iraq) could help overcome some of the problems involved.

Setting objectives, measuring results

Another characteristic of current donor practice concerns objective setting and measuring results. Here the main issue lies in the tension between ambition and realism. Donors' tolerance of aid risks seems to depend largely on the strategic priority given to a particular context and on the perceived potential of a particular aid intervention to contribute to wider strategic objectives (peace, statebuilding, etc.). The result is that implementing partners tend to overstate what they can achieve and to understate the time and resources it will take to achieve it. Donor tolerance for this kind of "built-in" risk of programme failure is too high, creating false expectations about what can be achieved through aid.

Risk cultures

Many donors have organisational cultures whose incentive structures tend to discourage appropriate risk taking. Most of the donors interviewed stated their desire to foster innovation, initiative and appropriate risk taking by staff members; yet few could claim that such behaviour was rewarded in practice. The same was felt to be true of the culture in many UN bodies and the World Bank, where "playing it safe" appears to be the dominant approach. These issues of risk appetite and organisational incentives are crucial – as is the issue of political cover for those expected to take risks on the organisation's behalf.

Recommendations

Overall, we conclude that current donor behaviour and systems are too risk-averse to achieve the desired results. They are risk-averse in *where* they engage and in *how* they engage. Based on this analysis, we make the following policy recommendations for donors:

- Establish a culture which encourages appropriate risk taking. This includes giving incentives to staff or implementing agencies to

take calculated risks; removing disincentives for taking risks; and ensuring political cover for risk takers if initiatives fail.

- Create funding and finance mechanisms which are more flexible, reduce transaction costs and increase speed of disbursement.
- Agree, with other donors, risk concepts and terminology and strengthen the use of joint risk assessment and analysis.
- Set more realistic objectives and criteria for measuring "success" when working in fragile and risky contexts.
- Accept that working in fragile contexts inevitably involves a higher degree of exposure to corruption and the misuse of aid. Current approaches to controlling corruption and other fiduciary risks are stifling effectiveness.
- Share risks with other donors and maximise collective impact by pooling efforts and funding. Concerted donor approaches to risk management work better than bilateral approaches.

Chapter 1

Aid, risk and state fragility

This chapter sets the scene by outlining what is meant by risk and risk management in the context of fragile and transitional settings. A new risk framework is presented, based on three categories: contextual, programmatic *and* institutional *risk. The authors define key terms, such as "fragile", "transitional", "risk" and "risk management". They suggest that these definitions should be adopted by all DAC donors to allow for a more integrated analysis of risk and opportunity.*

The chapter also outlines the range of international principles for donor engagement, some of which are contradictory when applied to work in fragile and transitional contexts. It explores some of these dilemmas, and concludes by emphasising that short-term, ad hoc*, incoherent and poorly co-ordinated national and international interventions will not be successful. Several donors are now advocating more holistic and joined up approaches to working in these settings, and their approaches are briefly described.*

In the aftermath of the 9/11 terrorist attacks in 2001,[1] the international community has become increasingly concerned about fragile and conflict-affected situations. Perceptions of the risks posed (internally and externally) by these situations and new thinking about how to respond to the challenges they raise have led to a dramatic reorientation of international policy in the past decade. Prior to the 9/11 attacks, fragile states tended to be seen as countries with serious development challenges, but with little strategic significance for OECD countries. Consequently, their problems were perceived primarily as developmental and humanitarian, and fragility was treated as a challenge for programme delivery rather than as an agenda in its own right. After the attacks, fragile states have become increasingly important on the international agenda and have become linked to a range of threats such as transnational crime; trafficking in weapons, drugs and people; the spread of disease; intra-state and regional violent conflict; genocide; and terrorism.[2] As such, the fragile states issue has developed into a comprehensive agenda that straddles multiple domains, including international foreign policy, security and development co-operation.

Today there are four overall reasons given for donors to engage in fragile states:

1. Providing support to peacebuilding processes.
2. Improving the development situation (*e.g.* advancing the Millennium Development Goals).
3. Promoting human rights.
4. Strengthening regional and global security by creating resilient states.

Donor governments are increasingly seeing development in fragile states in this wider foreign policy context. The past few years have witnessed a growing convergence of development, security, peacebuilding, statebuilding and related agendas in post-conflict and transitional contexts. Afghanistan and Iraq are just two of the more high-profile examples. These are high risk environments in a number of senses, with outcomes that are hard to influence.

This report considers the whole range of risks involved in working in such fragile and transitional contexts (Box 1.1), the ways in which these are viewed and managed, and the way in which one set of risks is balanced against another. The purpose is to consider whether current approaches to risk are appropriate and whether alternative approaches could be more effective. The study is based on interviews with donor and UN staff at headquarters mainly in 2010 (Annex C), and on a review of documentation (policy, procedures, evaluations) and relevant published literature (see Annex F for the terms of reference).

The report considers the rules that should guide aid interventions in such contexts. The Paris/Accra principles, which help to ensure that aid is effective (Box 1.5), assume a degree of state capacity that may be lacking in transitional contexts. To some extent, the Principles for Good International Engagement in Fragile States help to answer the question by stressing adaptation to context and the centrality of statebuilding. But to what extent do donors need to adapt normal development rules of engagement, standards and operating procedures? How well do humanitarian principles and modes of operation fit with others and which principles apply to different types of engagement or at different stages of transition? How do multiple overlapping agendas (aid, statebuilding, security) shape this? These overarching problems confronting any engagement in fragile states have a particular resonance when considered from the perspective of risk, since each poses different questions about risk taking. Consensus appears to be emerging that current models of aid engagement are unable to achieve the desired outcomes in fragile or transitional contexts; and, specifically, that aid providers may need to be more willing to take risks that might be considered unacceptable in other contexts.

This study is concerned with the last of these propositions: that aid providers should be more willing to take risks (and be less risk-averse) when engaging in fragile and transitional situations. But what does this actually mean for OECD DAC donors, and the organisations (particularly UN agencies) and governments that they fund? Being more willing to take risks might mean:

- Being more flexible in financing procedures. A recent paper on transition financing suggests that greater flexibility and adaptation to context are indeed required in this area (OECD, 2010).
- Being prepared to accept a lower degree of accountability in financial reporting or the demonstration of results (but with due respect to the Paris principles). This may mean recognising that being "effective" in this type of environment demands a different approach to that adopted in more stable contexts, including being prepared to live with less control (and its attendant risks) and more uncertainty.
- Being more innovative in programming: being willing to risk untested and uncertain new approaches rather than the standard repertoire of humanitarian and development responses. The need to innovate appears to go with the need to adapt to context, but more radical forms of innovation (such as general cash distribution) may be thought to increase risk in a given context and run contrary to the OECD fragile state principle of "do no harm" (Box 1.5). In other words, we might risk not just programme failure, but active harm to people or processes. A parallel might be drawn with radical but untested medical treatments,

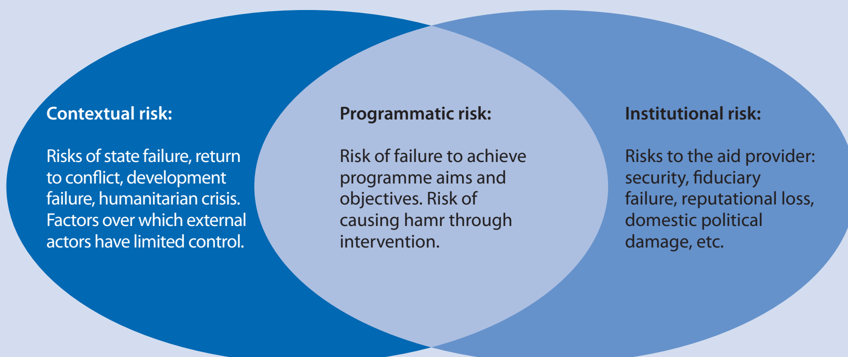
where the degree of risk involved has to be measured against the threat that the patient faces.

- Being more tolerant of things going wrong. Rather than focusing only on the negative, we need also to consider the potential for things to go *right*. In other words, we need to consider not just risk, but *opportunity* – including the opportunity cost of non-engagement. What the financial sector calls "upside risk" is an essential part of the analysis, without which judgements about risk and risk management cannot be properly assessed. This question of risk-gain calculation and the related issue of cost-benefit analysis are considered below.

This report is structured as follows: Chapter 1 summarises what is meant by risk and risk management in the context of fragile and transitional settings. Chapter 2 considers the range of ways in which risk features in current donor policy and analysis, while Chapter 3 reviews current approaches to risk management in high-risk environments. In Chapter 4 we consider some of

Box 1.1. **Categories of risk**

- ***Contextual*** (or country, situational or external) risk: the range of potential adverse outcomes that could arise in a certain context: the risk of political destabilisation, a return to violent conflict, failure to develop, a humanitarian crisis and so on. It includes the risk of harm spreading beyond the country's borders.
- ***Programmatic*** (or intervention) risk relates to the risk of programme failure, *i.e.* the potential for interventions not to achieve their objectives or to exacerbate contextual risk.
- ***Institutional*** (or internal) risk relates to the range of potential adverse consequences of intervention for the implementing organisation and its staff. These consequences could range from management and fiduciary failure to reputational or political damage.



the ways in which the issues identified in the previous chapters might be tackled, including methods used by the private and public sectors to assess and manage risk. Chapter 5 sets out conclusions and recommendations for DAC donors in particular and for the organisations that they fund.

What risks are involved? A new typology

Box 1.1. summarises the relationship between three categories of risk: *contextual*, *programmatic* and *institutional* risk. These categories are neither exhaustive nor definitive, and there is some overlap among them. But we believe the typology provides a useful common basis for discussion about risk in a field where ambiguity creates misunderstanding.

Contextual risk

This category covers the range of potential adverse outcomes that may arise in a particular context, including the risk of harm beyond the immediate context or the country's borders. Individual contextual risks are defined by the particular setting, but some common types of *risk outcome* might be grouped as follows:

- Political and social risks, *e.g.* the destabilising of a political settlement, the breakdown of relations within and between communities, and the resumption of conflict.
- Economic and developmental risks, *e.g.* negative growth, rampant inflation, failure to achieve the MDGs; and the failure of state service provision.
- The risk of humanitarian crisis and displacement, including refugee flows.
- Risks related to security/law and order, including transnational crime.

The *risk factors* that underlie these various categories depend on the context, but they may include governance failure (*e.g.* the failure of effective public financial management or law enforcement); competition for resources; natural hazards; and pre-existing socio-political tensions. Here, many of the risk outcomes are themselves risk factors for other types of risk, *e.g.* an economic crisis may trigger conflict and a humanitarian crisis. The complex interplay among different factors makes contextual risk analysis difficult and highly dependent on good local knowledge.

Programmatic risk

We use the term "programmatic risk" to include two kinds of risk: *(1)* the potential for an aid programme to fail to achieve its objectives; and *(2)* the potential for the programme to cause harm in the external environment.

With regard to *(1)*, the *risk factors* for programme failure include many of the contextual risks outlined above, as well as institutional and political factors. But there are many other reasons for potential programme failure. These include inadequate understanding of the context or flawed assessment of what needs to be done; management and operational failures; and failures of planning and co-ordination. Risk is also associated with new or innovative programme approaches (although there may also be risk in *failing to innovate*). One common reason for failure to achieve programme objectives is that the objectives themselves are simply too ambitious, either in their nature or time frames. Indeed, over-ambitious objectives seem to be a common side effect of the political search for peace dividends in post-conflict settings.

With regard to *(2)*, programme interventions may both exacerbate and mitigate contextual risks. This includes the potential for aid to do damage to the economy or to the government of the country in question, or to exacerbate conflict and social divisions. The *risk outcomes* include:

- The inadvertent fuelling of conflict by aid that becomes part of a war economy or black economy, making aid recipients vulnerable.
- Unintended political bias in the effects of aid, *e.g.* impacts on power-sharing and transitional arrangements that create "winners" and "losers" or reinforce elites.
- Strategic failure resulting from donors' inability to co-ordinate their political strategies.
- Political risks for the recipient government associated with donor-driven rather than country-driven aid support (perceptions of the government being a puppet, etc.), as opposed to political kudos associated with securing aid deals.
- Negative impact of aid flows on macroeconomic stability (*e.g.* inflation), as opposed to the capacity to mobilise domestic revenues and stimulate the economy through investment, etc.
- Economic risks and opportunities linked to using local instead of international procurement (this also relates to political risk).

Institutional risk

This category includes "internal" risk from the perspective of the donor or its implementing partners. It includes the range of ways in which an organisation and its staff or stakeholders may be adversely affected by interventions in fragile states. These risks can be further categorised as follows:

- Operational security risks: *e.g.* threats to the safety of staff and partners or the continuity of programmes, etc.
- Financial and fiduciary risk: *e.g.* financial loss and risk of institutional liability for loss/failure resulting from corruption or financial mismanagement.
- Reputational risk: *e.g.* damage to a donor's reputation if it fails to achieve its objectives, or from financial/fiduciary failure.
- Political and reputational risk from engaging in countries where the appropriateness of aid support is questioned or where aid appears to support violent/corrupt groups.

In interviews for this study, the two types of risk that featured consistently were reputational or political risk. Reputational risk may result from a donor failing to apply the agreed principles of good donorship, or perhaps from running too high a fiduciary risk and being exposed to criticism as a result. Political risk may result from this or other factors. There is a degree of political risk, for example, in dealing with certain non-state actors – *e.g.* organisations

Box 1.2. **Non-state providers in violent contexts**

In contexts such as Ethiopia, Sri Lanka and Sudan, opposition movements seeking legitimacy have in the past provided a wide range of services to underserved populations. In some cases, these groups are eventually brought into the national government after the resolution of the conflict. It is difficult for donors to decide how to deal with these movements in the context of violent conflict. This difficulty is increased when dealing with groups that have been designated as terrorist organisations, but also have strong political support in the country. This has been a major issue recently when international agencies and bilateral donors had to decide whether or not to engage with Hezbollah and Hamas – and if so, how. In this case, donors consider the political risks of direct engagement to be too high, and most are reluctant to sanction even indirect engagement through partner agencies. Indeed, the US legislature has made such engagement a matter of criminal liability (through the 2001 USA PATRIOT Act).

Source: Adapted from OECD-DAC (2007).

that are proscribed or on the "terrorist list" – whether through the aid programme or otherwise (Box 1.2). A number of donors described in interviews for this study how sensitive this issue was for ministers and their domestic political constituencies. This and corruption appear to be the areas of highest sensitivity. We consider later how judgements about these kinds of risk feature in decision making, how these risks are managed and what degree of tolerance there is for running such risks.

Concepts and definitions: fragility, transition, risk

Fragility

Much has been written about "fragile" states (or fragile situations). While definitions vary, there is considerable overlap. According to the OECD, "[s]tates are fragile when state structures lack political will and/or capacity to provide the basic functions needed for poverty reduction, development and to safeguard the security and human rights of their populations." (OECD, 2007).

For the World Bank, fragile states "share a common fragility, in two particular respects: State policies and institutions are weak in these countries: making them vulnerable in their capacity to deliver services to their citizens, to control corruption, or to provide for sufficient voice and accountability. They face risks of conflict and political instability." (World Bank, 2005).

The World Bank's definition is more obviously oriented towards risk and stability, perhaps reflecting an investment perspective; the OECD's is more focused on function and performance, reflecting an aid perspective. We consider these and other perspectives in this study.

The broad category of fragile states covers a number of quite different situations. As the OECD Principles for Good International Engagement in Fragile States state: "It is particularly important to recognise the different constraints of capacity, political will and legitimacy, and the differences between: *(1)* post-conflict/crisis or political transition situations; *(2)* deteriorating governance environments; *(3)* gradual improvement; and *(4)* prolonged crisis or impasse." (See Box 1.5)

Ultimately, there is limited utility in attempting neat categorisations or typologies of fragile states, since the concept itself is not coherent and contexts of this kind are too diverse to be easily classified. For the purposes of this study, we consider fragility in relation to the dynamics of transition from unstable to more stable structures and processes, including the political settlement involved, the structures of government, the security context, social cohesion, livelihoods and other economic factors.

Transition

The idea of "transition" is even less well defined than "fragility". It implies something dynamic, better reflecting the kinds of situation we are concerned with. Whether a situation is "transitional" – and in transition to what? – depends on how a given context is seen. There are broadly three types of transition.

1. Most commonly, the term is used to describe a *positive* transition from conflict to peace, from violence to security or from political instability to political stability. Sometimes it refers to a "standard" political transition process: from war and a ceasefire via a peace agreement to a new political settlement, new government arrangements, "transition measures" and elections. This is rarely a smooth or linear process, and no standard model can be applied, but it is the transition from conflict and insecurity towards peace and security that forms the context for most of the discussion in this study. Such transitions include and are underpinned by transitions in the state institutions, including justice and security, ministries, and local government bodies. These processes happen at national, provincial and local levels.

2. A second form of transition lies in the changing conditions affecting people's everyday lives, in particular economic, social and security conditions. Such changes include:

   - the evolving local security picture;
   - the process of the disarmament and demobilisation of soldiers (and related issues of employment);
   - the recovery of households and livelihoods;
   - the return and reintegration of displaced populations; and
   - the re-formation of communities and local institutions.

   Significant demographic changes and land issues may also be closely linked to the political transition both by cause and effect.

3. A third category is the transition from one form of assistance to another, and processes of international engagement and the link between them. In the traditional aid sphere, this commonly refers to the transition between humanitarian, recovery and development approaches. But this picture is complicated when one factors in statebuilding and peacebuilding and related programmes: security sector reform (SSR); disarmament, demobilisation and reintegration (DDR); transitional justice, etc. This is even more the case when these programmes occur alongside peace-keeping or peace enforcement operations carried out

by international armed forces, perhaps working with national forces. Indeed, a new category of transitional programming has emerged in recent years, reflecting the reality that neither traditional humanitarian nor developmental approaches on their own may be adequate to engage with the kinds of transitional processes described above (OECD, 2010). This suggests that rather than being sequential, such approaches may need to be pursued in parallel.

It is against this backdrop, and particularly the first two categories referred to above, that policy formulation and transitions need to be designed and managed. Failing to understand the nature of the external transitions, the factors driving them and the inherent risk is likely to lead to a failure either of policy or implementation, or both. South Sudan is one of a number of recent examples where this has proved true (Pantuliano *et al.*, 2008). Failure in one aspect of transition can threaten successful transition as a whole.

The risk that defines international interest in these contexts is that the transitions concerned will stall or go into reverse; or will otherwise lead to outcomes that seriously threaten international interests. In particular, concern centres on the risk of a return to conflict and violent instability; or that the transition leads to the emergence of political regimes whose policies threaten international interests, including peace and security. It is against this backdrop that decisions about intervention are made and (increasingly) that aid effectiveness is judged.

Risk

Risk is an elusive concept (Box 1.3). It can be expressed in general terms as *the possibility of future harm* – where "harm" is taken to mean any undesired event or outcome. All statements about risk involve propositions about the (uncertain) future. Specifically, they involve propositions about the probability of an undesired event or outcome occurring, and they may state this probability more or less precisely. To say that a venture is "risky" can be interpreted in many different ways: that there is a risk it may fail, cause harm to those who engage in it, cause harm to others, and so on. Unless we specify *what* that event/outcome is, how or to whom it is harmful, and how likely it is to occur, then the risk proposition is incomplete. We have to ask: risky for whom, how and to what extent? Two aspects of risk in particular are often considered: the *likelihood* of an event or outcome occurring and the likely *severity* of its impact. These parameters are often used to rank and prioritise risks.[3]

Box 1.3. **Risk terminology**

Discussions about risk are complicated by the fact that the term is applied to a number of different *kinds* of thing. In this report we use the following definitions:

1. **Risk:** the *potential* for a defined adverse event or outcome to occur.
2. **Risk outcome:** the adverse event or outcome itself, *i.e.* the result of the risk being realised.
3. **Risk factors:** factors that may cause the risk outcome to occur, or make it more likely. Multiple interacting factors give rise to compound risk.

In practice, "risk" tends to be used interchangeably to refer to definitions (1) and (2) and sometimes also to risk factors. This can be confusing. So, for example, in the aid context, "political risk" may be used to refer to the risk of domestic political damage to the donor (institutional risk); to adverse political outcomes in the fragile context as a result of the intervention (programmatic risk); or to political factors in the external environment that may cause programmes to fail (contextual risk factors; Box 1.1). Clearly, it is important to specify what is meant in a given context.

Risk management

If risk is about the future, risk management – or, more specifically, risk *reduction* – is about the attempt to manage the future by taking action now to eliminate or mitigate known risk factors. This poses some obvious challenges. The first is an analytical one: we need to be able to identify the key risk factors and determine how (if at all) we can change them. Risk analysis depends on our ability to foresee the potential course of events and identify critical outcomes based on our knowledge of the past and present. Our knowledge is usually incomplete, and in any case we may not be able to use it successfully to predict the future, especially if human behavioural factors are involved. In addition, we may not be able to judge with any certainty the effect of any action we take on future outcomes.

The second challenge to risk reduction is a practical and strategic one: how should we intervene to reduce risk? Even if we can foresee the future, we may not be able to influence the causal factors to change the future or reduce the probability of adverse outcomes. This may be particularly true in fragile states. The third main challenge is one of changing behaviour. Even if we think we can predict the future and have ways of managing (changing) it, we still have to persuade other people that we are right – and that they should do something about it. There may be all kinds of reasons – political, economic,

social, psychological – why people may be reluctant to take preventive action despite a credible analysis of likely future harm to themselves or others.

This discussion assumes that our goal is to reduce or eliminate risk. Yet most worthwhile endeavours depend on taking some risk. Avoiding risk may harm our chances of succeeding in such endeavours. Achieving our goals often entails accepting a degree of risk. The more risk-averse we are, the narrower may be the range of achievable goals. Not only that – our attempts to reduce risk may frustrate the very objective we have set out to achieve.

For this reason, risk management is *not* just about risk reduction: it is also about balancing risk and opportunity in such a way as to ensure the best overall outcome.[4] In Chapter 4 we consider some of the elements of risk management that are common in the private and public sectors. Balancing risk and opportunity in the public domain is clearly not without limits: some risks may be simply unacceptable to the institution concerned. Being clear about this "bottom line" is essential in defining the parameters for appropriate risk management in any given context.

Objective setting and accountability for aid outcomes

We are mainly concerned with two kinds of outcomes in thinking about risk management in fragile contexts:

4. Outcomes we want our intervention to achieve or prevent. This might include stability or the absence of violence; stronger, better-governed state institutions; or access by all children to adequate nutrition and health care.

5. Unintended adverse consequences of our intervention.

The first category is concerned with tackling factors in the external environment that are critical to achieving such outcomes. In fragile and transitional contexts, many of these are risk factors that threaten the achievement of wider goals; in other words, failing to achieve these outcomes increases the risk of state failure in various ways. Increasingly, interventions in this category include both primary objectives (*e.g.* health service delivery) and secondary or "meta-objectives" (such as statebuilding).

The second category is more concerned with avoiding risk: we foresee potential negative outcomes from our intervention – either for ourselves or those we aim to assist – and we seek to mitigate or eliminate such effects. This would include the risk of fuelling corruption or being unable to account for the use of disbursed funds. It would also include unintended negative effects on the political economy of the situation – our efforts to make things better could make things worse.

One of the themes of this study is the tension between these two outcome categories and the ways in which we try to control or influence them. In particular, our attempts to avoid risk may jeopardise the achievement of our intended outcomes. There are trade-offs here. At one extreme, concern about the "unintended consequences" may lead us not to intervene at all; or it may cause us to intervene in ways that are highly conservative, restricted and inflexible. Finding the right balance is key – and what constitutes the right balance will almost certainly change over time and require regular reappraisal.

Difficulties arise even within the first category. It is relatively easier to account for and gauge the impact of the primary type of objectives noted above, which typically involve service delivery or asset transfer. "Meta-objectives" like peace or statebuilding are harder to account for and require a broader frame of reference, generally including longer time frames. Standard project accountability frameworks may simply be inadequate to the task.

Programming in fragile and transitional contexts is inherently risky, in that we may have relatively limited control over the outcomes (Box 1.4). The risk of failure may be very high, and we may in any case struggle to

Box 1.4. **What can we influence?**

Risk management can involve dealing with a range of situations:

1. Those characterised by events and outcomes that no-one can control or influence.
2. Those where multiple factors influence the outcome and we may have little or no control.
3. Those where we have a high degree of influence/control over the outcome.
4. Those where the outcome is entirely within our control.

The first of these situations is unusual: events that are apparently random or unpredictable may be a feature of fragile settings, but they are generally a function of complexity (category 2) rather than chance. Similarly, few aid interventions fall into category (4), other than in the most narrow, output-oriented sense. Most fall into categories (2) or (3), and the question is what measures have to be adopted to maximise the chance of the outcome occurring. One characteristic of interventions in fragile and conflict-affected settings is that the ability of individual initiatives to influence outcomes may be very limited.

Which category a given intervention falls into depends largely on how the objectives of the intervention are framed, in particular whether they are expressed in terms of outputs or outcomes, and how broadly or narrowly such objectives are framed. The failure of a programme to achieve its objectives may be a question of how realistic these objectives were to begin with, given the context. In that sense, programmatic risk may be "built in" to a given programme.

demonstrate a clear link between our intervention and positive outcomes, particularly where those outcomes are expressed in qualitative or process terms. This sits uncomfortably with the dominant management culture in most aid bureaucracies and with demands for public sector accountability against outcomes. To say that we "contributed to change", even assuming we can plausibly demonstrate it, may not satisfy demands for accountability – although some donors now express their results in terms of contribution rather than causal attribution.[5] In this context, the question of *collective* impact becomes especially important and the risk inherent in failing to co-ordinate strategy is particularly high.

That said, outcomes are rarely "all or nothing". We may achieve partial or incremental improvements – and "percentage" change may translate into thousands of children surviving or thousands of people regaining secure livelihoods. Sometimes progress will be reversed by events outside our control, but even modest achievements may lay the foundations for longer-term progress. The risk of set-back or failure tends to be high in fragile contexts, particularly where objectives are constructed around tight timeframes. But the question of what constitutes "success" (full or partial) when such success is needed to justify further investment or the continued use of a given approach often remains uncertain and depends on subjective judgement. "Failure", on the other hand, may be all too apparent. In calculating the proper balance between risk and opportunity, this is a fundamental problem.

International principles, agendas and frameworks

Donor engagement in fragile and transitional contexts is guided by a range of international principles and policy agendas (Box 1.5). This makes perceiving and calculating risk even more difficult, and achieving a coherent strategy even more challenging. International engagement in transition settings involves a growing range of overlapping agendas and objectives, including humanitarian response; early recovery; stabilisation; and peacebuilding, long-term development and statebuilding.

Our focus here is on perceptions and calculations of risk at the interface between donor strategy, policy and action in a given context, and the tensions, dilemmas and even contradictions that can emerge. We return to the wider question of risk perceptions and organisational culture in Chapter 2 of this report, and some specific policy dilemmas in Chapter 3. Here we are mainly concerned with the broader calculation of risk in relation to the impact of donor action on the external environment, *i.e.* with donor impact on *contextual* risk as defined above. The dominant principle here is the need to understand and minimise the potential for "doing harm" to the very political and social processes that donors' interventions are designed to support.

Box 1.5. **Principles for donors**

Over the last decade an array of principles to guide donor interventions has emerged to improve the quality of international intervention across a range of policy agendas. **The Paris Declaration on Aid Effectiveness** (PD) signed in 2005 and the Accra Agenda for Action of 2008 guide effective aid interventions:

1. Ownership – Developing countries set their own strategies for poverty reduction, improve their institutions and tackle corruption.
2. Alignment – Donor countries align behind these objectives and use local systems.
3. Harmonisation – Donor countries co-ordinate, simplify procedures and share information to avoid duplication.
4. Results – Developing countries and donors shift focus to development results and results get measured.
5. Mutual accountability – Donors and partners are accountable for development results.

More details: www.oecd.org/document/18/0,3746,en_2649_3236398_35401554_1_1_1_1,00&&en-USS_01DBC.html.

The **Principles for International Engagement in Fragile States and Situations** (FSP) signed in 2007 provide a set of guidelines to improve involvement of the international community in situations of conflict and fragility:

1. Take context as the starting point.
2. Ensure all activities do no harm.
3. Focus on statebuilding as the central objective.
4. Prioritise prevention.
5. Recognise the links between political, security and development objectives.
6. Promote non discrimination as a basis for inclusive and stable societies.
7. Align with local priorities in different ways and in different contexts.
8. Agree on practical co-ordination mechanisms between international actors.
9. Act fast… but stay engaged long enough to give success a chance.
10. Avoid pockets of exclusion (“aid orphans”).

More details: www.oecd.org/document/46/0,3343,en_2649_33693550_35233262_1_1_1_1,00.html.

Box 1.5. **Principles for donors** *(continued)*

The **Good Humanitarian Donorship** (GHD) principles focus on the challenges of good humanitarian practice in such contexts. There are 23 such principles, agreed in 2003. They provide both a framework to guide official humanitarian aid and a mechanism for encouraging greater donor accountability. These were drawn up to enhance the coherence and effectiveness of donor action, as well as their accountability to beneficiaries, implementing organisations and domestic constituencies, with regard to the funding, co-ordination, follow-up and evaluation of such actions.

More details: www.goodhumanitariandonorship.org.

In fragile and transitional settings, donors are guided by sets of principles that may appear to point in different directions. They need to find ways of reconciling the broad range of objectives included in the different policy agendas that they pursue. A closer look at the issue of principles and policy objectives reveals a number of dilemmas and associated risk factors. While risk management at a programmatic level is an established part of donor engagement, broader analysis of contextual risk and the dilemmas that may arise in relation to policy objectives and outcomes is still under-developed (see OECD, 2010; Paris and Sisk, 2009; OECD, 2009). Recent research indicates that analysis of context and conflict risk tends to be fragmented and not shared, either within or between donor governments (OECD, 2009).

Risk analysis – at least of contextual risk – is perhaps more familiar to those working in humanitarian engagement than those working closer to the development end of the spectrum. In humanitarian work, contingency planning, preparedness and risk reduction measures are core business, although the quality of the available analysis is variable and few comprehensive risk analysis mechanisms exist. Famine early warning systems, health information systems, disease and malnutrition surveillance systems and other such mechanisms allow some basic human risk factors to be monitored in more or less real time. Changes in security are less well analysed, including the security context for aid programme staff in the field, although this is now receiving more attention (Harmer *et al.*, 2009). Changes in livelihood and income patterns are not monitored consistently. At the more ambitious end of the development agenda – which for fragile states now includes elements like statebuilding – the political, economic and social risk factors demand a depth of analysis that often appears to be lacking. Part of the problem relates to the difficulty of identifying agreed ways of measuring and assessing these factors. There are no generally accepted models here, and much depends on the judgement of individuals and their depth of understanding of the context in which they are operating.

How those focusing on development perceive aid risk and the "do no harm" principle is likely to differ from how it is perceived by those concerned with stabilisation or security. Ministries of defence perceive risk in very different ways to aid agencies, both in terms of contextual risk and programme or institutional risk (see Chapter 2). One consequence is an increase in the risk of fragmentation and incoherence of donor engagement, both within and among donor governments. Changing calculations of political risk lead to increasingly incoherent policies over time. Countering these tendencies requires a more integrated analysis of risk and opportunity, something that has been recognised in recent "3Cs" approaches to whole-of-government policy formulation (to ensure policy that is coherent, co-ordinated and complementary).[6] But some differences may be irreconcilable, since the widely differing policy agendas involved often make them incompatible.

Tensions and contradictions

The sets of principles described in Box 1.5. provide different kinds of guidance to policy makers. This can lead to contradictions and tensions at the programming and operational level. Two recent studies assess the applicability of the PD and the FSP in fragile states (OECD, 2009; OPM/IDL, 2008). The Oxford Policy Management study looks at the challenges of trying to implement the Paris Declaration principles of ownership, alignment, managing for results and mutual accountability where national government capacity, control and legitimacy are problematic; where governance is deteriorating; or in conflict-prone situations. Trying to promote partner country ownership or aligning with the priorities of poor performers – particularly where the poor performance relates to human rights or corruption – is problematic. It can undermine the GHD principle of "do no harm" (because it is likely to perpetuate abuses) and can also damage the reputation of donors. *Harmonisation* is the one PD principle that remains unequivocally relevant. Where transition or post-conflict settings indicate more "hopeful partnerships" (OPM, 2008), some of the other PD principles begin to acquire increasing relevance, including building country ownership.

The FSP are much more relevant in guiding donor action in fragile contexts, although principally in terms of statebuilding. However, despite the pragmatic nature of the FSP, their application is less straightforward (OECD, 2009) and can open up dilemmas and potential trade-offs across different policy objectives and agendas. For example, prevailing wisdom on international engagement in fragile situations encourages greater flexibility in donor engagement to allow for quicker adaptation to rapidly changing circumstances and to not be afraid of taking some risk. Indeed, Principle 9 of the FSP talks of the need to "Act fast … to take advantage of windows of opportunity and respond to the changing conditions on the ground." On the other hand, the

GHD imperative to "do no harm" – together with increasingly strict donor accountability requirements – may encourage donors to be risk averse.

Yet the UN Secretary-General requested that donors have a higher tolerance for risk: "I look forward to an early outcome from the ongoing efforts of the [OECD-DAC] to revise donor procedures so as to allow earlier and faster release of funds in post-conflict situations with a higher tolerance of risk … *I urge donors to be bold and innovative in finding solutions that will establish flexible, rapid and predictable funding modalities for countries emerging from conflict.*" (UN, 2009; emphasis added)

Current fiduciary and reporting requirements raise a whole set of questions about good practice in these contexts. Decisions about strategy, policy, programming and implementation need to be made through an assessment of the related challenges and dilemmas of engagement in these contexts (Annex B); a sophisticated understanding of a range of often interrelated risks; and the ability to balance of risk and opportunity.

Among the donor policy documents reviewed for this study, those of the European Commission and the UK's Department for International Development (DFID) say the most about the dilemmas, challenges and trade-offs involved in engaging in fragile states. For example:

> *Donors and partner governments in fragile situations are faced with multiple dilemmas as they seek to balance competing objectives. There may be a situation in which everything is a priority, and there is always a risk that responses to short-term crises may undermine long-term processes. While trade-offs are unavoidable, good practice requires that donors and partner governments work together to establish tools and mechanisms that allow for the best balance to be struck between maximising the short-term positive impact of aid and building long-term sustainability of state institutions. (DFID, 2010a)*

A proper understanding of these challenges and trade-offs is essential for designing risk management strategies that allow donors to balance one risk against another. Since it is beyond the scope of the present report to consider this in detail, some of the main issues are highlighted in Annex B.

A more holistic donor approach to fragile and transitional situations[7]

Recent experiences in countries like Afghanistan and Iraq have shown that interventions can be highly complex and problematic, requiring the co-ordination of efforts in a wide range of domains. Traditional diplomatic and military instruments have often proved insufficient for advancing peacebuilding and statebuilding objectives, and must be complemented with

long-term development work. Development gains, meanwhile, can be sustained only with the provision of basic security and effective governance. Increasingly, the OECD highlights the fact that short-term, *ad hoc*, incoherent and poorly co-ordinated national and international interventions will not be successful. As a result, its focus has shifted to improving statebuilding capacities through more "joined-up", coherent working.

Most of the donors researched for this report follow the OECD in this new focus and treat fragile states as a distinct category in their development strategies. Many of them consider that the high levels of insecurity, political instability and social turmoil in fragile states present particular problems that cannot be addressed effectively through traditional approaches to development co-operation. They believe that innovative approaches are required to engage in such situations. The United Kingdom has a long record of engaging in fragile and insecure situations, and has published several reports and policy papers identifying these situations as an object of special concern in its development policy. In 2005, DFID called for efforts in fragile states to especially focus on improving donor co-ordination, governance reforms and service delivery (DFID, 2005). The 2009 White Paper (DFID, 2009) and the policy framework on peacebuilding and statebuilding that emerged from it strongly place conflict and fragility at the core of UK development co-operation.

Other donors are also increasing their focus on fragile states, not least the United States, the Netherlands and the European Union. In 2005 the US Agency for International Development (USAID) formulated a fragile states strategy, declaring that "[i]n countries that lack the ability, or will, to provide basic services or protection, we can no longer choose to look the other way. We need to engage in a coordinated and strategic manner to address the core issues of poverty and underdevelopment." (USAID, 2005a). It added that "[f]ragile states … pose a particularly thorny development challenge due to their overall weaknesses, particularly of their governance institutions." (USAID, 2005a).

In the Netherlands, the former minister for development co-operation identified fragile states as one of the four priorities of Dutch development co-operation when he took office. Consequently, the Netherlands Ministry of Foreign Affairs (MFA) developed a strategic framework for its engagements in fragile states, noting that it "… wants more attention to be given to fragile states, home to many of the world´s poorest people, to protect their human rights and help limit regional and global threats." (NL MFA, 2008). Similarly, the European Commission has published *Towards an EU Response to Situations of Fragility* (European Commission, 2007). This underlines that the EU is determined to address state fragility by, among other things, helping states strengthen their capabilities to fulfil their core functions, as well as strengthen constructive linkages between state institutions and society.

Australia, Canada, Denmark and Sweden have all increased their operational presence and programme expenditures in fragile states in recent years. However, unlike the EU, the Netherlands and the UK, none has made public a specific policy strategy guiding their efforts in these situations.[8] As described in Chapters 2 and 3, the absence of a specific policy framework may affect how interventions in fragile contexts are designed and managed. Of particular concern is the lack of different "context-specific" risk assessment and risk management tools for use in fragile situations. That said, even where there is no formal policy distinction between fragile and non-fragile situations, many donor aid bureaucracies do acknowledge this distinction in their day-to-day work, recognising that interventions in fragile states cannot be handled in the same way as traditional forms of development co-operation.[9] There is, however, a danger that the lack of a formal and publicly declared strategic framework reduces the political "cover" for donor staff, who need to base their decisions on internal guidance notes instead of on political directives.

The Canadian International Development Agency (CIDA), like other donor agencies in this group, has internal guidelines in place to guide its work in fragile states. These guidelines are largely procedural and operational, and not political in nature.[10] Fragile countries, as well as crisis-affected communities, constitute one of CIDA's main programme activities. The Canadian government has also established a special mechanism and related fund for engagement in unstable transitional contexts – the Stabilisation and Reconstruction Task Force (START). In addition to its programme and co-ordination roles, it is expected to provide "policy leadership on issues pertaining to countries in or at risk of crisis" where whole-of-government operations are mandated (see Chapter 3).

Several donors give particular emphasis to the security problems stemming from state fragility. The Danish Ministry of Foreign Affairs, for instance, states that "fragile states and conflicts pose particular challenges in relation to ensuring stability, democracy and respect for human rights, not only within a country but also in terms of regional security and development" (Danish MFA, 2009). Its Dutch counterpart observes that fragility can give rise to both regional instability and global threats: "When they give rise to cross-border terrorism, refugee flows and international crime, fragile states pose a global security risk and a direct threat to international and therefore Dutch interests." (NL MFA, 2008). Because of this, international donors have become more and more outspoken about their own interests in engaging in fragile and transitional situations. The concern with international security risks shows a growing appreciation for the fact that non-engagement in fragile contexts entails risks of its own – as the international disengagement from Afghanistan in the 1990s might well illustrate.

Notes

1. The attacks on the World Trade Center in New York and the Pentagon in Washington, DC on 11 September 2001.
2. New normative frameworks have arisen in the past decade that relate to such threats. These include the 2003 Rome Statute, which established the International Criminal Court; and the Responsibility to Protect doctrine enshrined in the 2005 World Summit Declaration of the UN General Assembly (following the report of the UN High-Level Panel on *Threats, Challenges and Change*).
3. See Annex A for an outline of some of the most common bases for risk analysis and related concepts like cost-benefit analysis.
4. ISO 31000 (2009) and its related Guide 73 define risk as the "effect of uncertainty on objectives", including both negative and positive impacts (or "downside" and "upside" risk). We do not use this definition, in part because it limits the application of risk to impacts on enterprises and their specific objectives, rather than risk outcomes more generally.
5. See, for example, DANIDA (2008).
6. For more on this approach, and the 3Cs Roadmap, see CSIS (2009).
7. This section is based on a desk review of key policy documentation and/or interviews conducted with representatives of the following OECD donors: Australia, Canada, Denmark, the European Commission, Germany, the Netherlands, Sweden and the United Kingdom (Annex D).
8. At the time of writing, Denmark is in the process of drawing up a fragile states strategy.
9. Interviews with staff of the Swedish International Development Co-operation Agency and the Danish MFA, and Canadian government officials, 10 February, 5 March and 19 April 2010, respectively.
10. Roundtable discussion with Canadian government and CIDA officials, 19 April 2010.

Chapter 2

Risk perceptions and analysis

Chapter 2 addresses three questions: (1) *How are risks dealt with in aid policy?;* (2) *How do donors currently assess risks and report on successes versus failures?; and* (3) *How do perceptions of risk vary and how can differences be bridged? It looks at whether taking risk and reporting results are compatible, and asks how we can break down vague and over-ambitious objectives into more realistic and tangible goals. It also points out that one of the greatest challenges in adopting a whole-of-government approach to fragile states is to bridge differences in organisational cultures. It concludes by describing how the donors who are more willing to take risks can lead the way, later to be followed by more cautious donors. It also emphasises that individuals need the support and backing of senior managers if they are to be encouraged to take appropriate risk.*

In this chapter we look at the ways in which aid actors perceive and analyse the three types of risk (contextual, programmatic, institutional) identified in Chapter 1. We do so by answering the following questions:

1. How are risks dealt with in aid policy?
2. How do donors currently assess risks and report on successes versus failures?
3. How do perceptions of risk vary and how can differences be bridged?

This and the following chapter (which looks at risk management) are based on a review of the literature and policy and procedural documentation, supplemented by the results of interviews of some of the main DAC donors, multilateral donor organisations and UN implementing agencies (see Annex D).

Two important caveats should be noted here. First, these chapters review approaches to risk and risk management primarily as seen through the eyes of donor government staff in headquarters, and through the lens of institutional procedures and policies. This does not necessarily reflect practice throughout an organisation, particularly at the field and programme implementation level. Practice depends in part on the way in which policy is understood and implemented and the amount of discretion given to regional and country offices or implementing partners.

Second, given the limits of the study, we have not been able to explore the perceptions of aid recipient countries, either the government or the population at large. Clearly, this is an essential matter for future consideration. National and international perspectives of contextual risk may be very different; and in the national sphere, differing priorities often lead to different perceptions of risk. For example, one of the most striking examples of the significance of different risk perspectives is the relatively low priority that tends to be given to risks affecting population groups such as destitute rural and urban families, that may be highly vulnerable to natural hazards and economic shocks, but which are politically and economically marginal. Risk is ever-present in the lives of such people, who often inhabit marginal land and depend on precarious livelihoods. Yet the vulnerability of these communities only tends to be a top priority in national and international aid policy when a humanitarian crisis occurs. In spite of the renewed prominence given to this topic by the climate change agenda, preventive action to reduce the risk of disaster remains one of the "orphans" of the aid agenda – as the recent floods in Pakistan remind us. Similarly, social protection mechanisms to help people recover from shocks and build resilience in the medium and longer term tend to be underfunded and grossly inadequate to the task. Besides the risk of conflict, exposure to hazards of this kind is one of the recurring characteristics of fragile states – and may in turn increase the likelihood of insecurity and political instability. Although further analysis of these and

other contextual risks involved in fragile settings is beyond the scope of this study, it forms an essential backdrop to the discussion that follows.

2.1. Risk in development and humanitarian policies

The concept of risk lies at the heart of much of the new thinking on fragile states. As noted in the previous section, many of the donors researched for this report acknowledge the higher risks of engaging in fragile states. The European Commission, the Netherlands and the UK are the most outspoken about this in their formal policies and strategies. For example:

> *The risks involved in working in fragile states are greater than those in other developing countries. Staff who are sent to these countries face significant risks. The political risks are also greater due to the fact that these are weak states with unstable political situations. Management risks are also considerable since the capacity of the government and implementing organisations is often more limited than in other developing countries. There is consequently a higher risk of misspending and corruption. There are also risks of interventions proving ineffective, since the overall situation could worsen rather than improve, thus undoing the intervention's effects. (NL MFA, 2008)*

DFID, in turn, speaks about fragile state engagement as "more complex peacebuilding and statebuilding processes, with greater potential to transform the long-term prospects of these countries, but with much higher levels of risk" (DFID, 2010b). The European Commission explains that "dealing effectively with fragility involves taking risks and requires rapidity and flexibility in adopting political decisions and making them operational in the field, while dealing simultaneously with partner countries´ constraints, often in terms of limited capacities" (European Commission, 2007). Germany makes a distinction between fragile and non-fragile states in its guidelines to using budget support as to provide aid, noting that "[d]ue to the higher risks posed by [fragile states], a policy decision in favour of budget support would only be taken in an exceptional case." (BMZ, 2008)

Other donors – usually those without official fragile states strategies – are less outspoken about the higher risks of intervening in fragile states. Australia, Canada, Denmark and Sweden do not formally distinguish in their development policies between risks linked to interventions in fragile states and those associated with other forms of development co-operation. Sweden, for example, has no separate framework for assessing or managing risks in fragile situations, only general guidelines that apply to all forms of development assistance. Denmark, in turn, has no specific guidelines for managing funds in transition situations. However, on an informal, programming or operational level these donors nevertheless tend to acknowledge the greater risks in fragile

states and the need to treat engagements in these contexts differently. One official with the Danish MFA, for instance, stated that although no specific guidelines exist for engagements in fragile situations, it is widely accepted that general development guidelines will need to be applied differently in these contexts.[1] An official with the Swedish International Development Co-operation Agency (Sida), in turn, stressed that "Sida acknowledges the need to take more risk when intervening in conflict-affected situations, but it is not clear how to take acceptable or calculated risks".[2]

Most donors acknowledge the higher risks of engaging in fragile states, because of the higher levels of insecurity, political instability and lack of partner capacity in these areas, but they also emphasise the urgent need to promote peace, security and development in fragile contexts. The European Commission describes fragile situations as "… a particular challenge as an obstacle to sustainable development, equitable growth and peace, creating regional instability, security risks at global level, uncontrolled migration flows, etc." and the German Federal Ministry for Economic Co-operation and Development (BMZ) stresses that "[f]ar-reaching policy changes and reform processes are necessary in these countries if the Millennium Development Goals are to be achieved" (BMZ, 2007). Similarly, in 2008 the UK's DFID announced that it is "… responding to humanitarian need, the economic costs of insecurity and the need to reduce poverty in insecure environments by increasing its emphasis on conflict prevention and on supporting 'fragile states'" (DFID, 2008).

2.2. How do donors assess and report risk?

Assessment frameworks

While most donors acknowledge that risks in fragile and conflict situations are higher than in traditional development contexts, only a few donors have risk assessment frameworks specially designed for these environments (Box 2.1). In some cases, however, they acknowledge the need to apply general frameworks differently in these contexts. This is the case in Denmark, where one respondent working for the MFA stated that "… of course, in fragile situations the risks are even higher, the timelines are shorter and there is a need to work collectively. The general rules may not apply in these situations."[3]

Some donors have frameworks or guidelines that lay out the risks and benefits of particular forms of engagement in different kinds of context. The EU is currently in the process of developing a framework for analysing the risks associated with providing budget support to fragile states.[4] While still in the draft stages, this framework is interesting because it gives attention to "tendencies of change" rather than just the overall weakness of financial systems in fragile states. In other words, it considers the potential for transition in public financial management rather than assuming a steady state. Among

Box 2.1. **The UK's Programme Risk Assessment Matrix**

Some donors do consider the risks associated with engaging in fragile states separately from the general risks of development co-operation. DFID´s Middle East and North Africa Department (MENAD) has developed a Programme Risk Assessment Matrix (PRAM) that it claims is "… particularly relevant to conflict and fragility" (DFID, 2010b). The PRAM, which is updated at six-monthly intervals, monitors risk and performance across three country programmes (Iraq, the Occupied Palestinian Territories and Yemen) and the regional programme. Its data consist of a summary of portfolio performances and trends, one-page risk summaries for each country and the region, a table with monthly performance scores for all ongoing programmes, and detailed reports for each individual programme. According to DFID, the strength of the PRAM is that the "… regular assessment obliges both country offices and the MENAD to keep levels of risk and impact on operations under constant review. If the same risks and responses are recurring, managers should take remedial action" (DFID, 2010b). Furthermore, the PRAM enables MENAD to keep an eye on both individual country situations and regional trends, and facilitates information sharing across programmes.

other things, it examines the recent evolution of the macroeconomic situation in the country and the region, recent changes in budgetary processes, and whether a national programme exists that is capable of introducing credible and coherent financial reforms. It also outlines (as far as is possible) remedies for particular risk factors. While many donors reject outright the provision of budget support in fragile situations, the EU framework may help to highlight important nuances that exist in different fragile states.

In a report on fragile state engagements, the German Federal Ministry for Economic Co-operation and Development (BMZ) also focuses attention on "tendencies of change". Categorising fragile states according to government performance and development orientation, the BMZ notes that governments that are demonstrably more development oriented make worthier candidates for close collaboration and may even qualify for programme-oriented joint financing (PJF) measures. Budget support, however, will be provided only in exceptional cases (BMZ, 2007). A related document on budget support states: "In principle, PJF can be granted to [fragile states], provided that notwithstanding their low governance levels they show a clear and positive trend in government performance (development orientation, political commitment to reform, readiness to engage in dialogue)" (BMZ, 2008). Such distinctions are a helpful reminder that interventions in fragile states should seek to encourage positive tendencies, not simply reward past achievements.

Many other donors do not have specific frameworks for assessing risks in fragile states, but instead use general risk assessment frameworks for all forms of development co-operation. Sweden, Australia and Canada all have single sets of risk assessment guidelines for general development engagements. The Swedish risk assessment procedure is based on a process of first documenting and valuing risks, then analysing and appraising them in terms of acceptability (Sida, 2009). The Australian Agency for International Development assesses risks in three steps: *(1)* identifying risks; *(2)* analysing their likelihood and consequences; and *(3)* ranking risks against priority criteria (AusAID, 2005). This in turn resembles methods that CIDA uses, where the risk assessment process consists of *(1)* identifying risks; *(2)* evaluating them in terms of likelihood and impact; and *(3)* ranking them based on this evaluation (CIDA, 2010). In many respects, these procedures may also promote effective risk management in fragile contexts – but without the necessary step of balancing competing risks and weighing them against opportunities. As noted above, reducing risk in one area can increase it in another – and too exclusive a focus on risk reduction may have a negative overall effect.

It is interesting to note the different risk categories used by donors. There is clearly no single way of understanding and grouping risks; instead, donors have developed an array of typologies and definitions based on their perceptions of the risks of development co-operation. MENAD's PRAM (Box 2.1) identifies three broad categories of risk: country risks, partner risks and programme/ project risks. Country risks affect "… the broader environment in which DFID is operating, including the internal and external political context, levels of insecurity and violence, and events and processes that may impact DFID's operations at a strategic level." Partner risks are linked to low partner capacity or weak political will in the partner country,[5] but also include fiduciary and corruption risks. Finally, programme and project risks affect the implementation of programmes and projects, including security risks and risks linked to infrastructure and supplies[6] (DFID, 2010b). Sida categorises risk in different terms altogether. Its report *Integrated Risk and Results Management* defines risks in terms of their effects on "output efficiency", "outcome effectiveness", "outcome relevance" and "outcome sustainability" (Sida, 2009). This provides the analytical distinctions that are fed into a risk management framework that is explicitly results oriented.

CIDA uses a different results-based risk assessment framework, where the overall categories include operational risks, financial risks, development risks and reputational risks (CIDA, 2010). Each of these broader sets is then sub-divided into more specific risk types. For example, operational risks include human resources risks, performance management risks and information systems risks; while financial risks consist of funding risks, fiduciary risks and contractual instrument risks. What is interesting about CIDA's risk assessment framework is that it is derived from and subordinated

to an overall risk management system used by the Government of Canada. CIDA follows similar risk standards and procedures to any other government department:

> *The government has a Corporate Risk Profile that identifies the main risks that need to be tackled in any planning profile or strategic planning. The risk analysis is to be conducted by different government bodies, looking into risks in relation to the Corporate Risk Profile and specifically related to the branch. The risk analyses are filled out and reviewed periodically. After that, the Corporate Risk Profile is updated based on the information provided. The objective is to keep the risk analysis as simple as possible and standardised as much as possible so that everybody is using the same methodology.*[7]

The use of a standardised framework covering all state departments may of course be too rigid when applied to specific policy initiatives, and also ill-suited to fragile contexts, where greater flexibility may be necessary. However, as Canadian government officials were careful to stress, the standardised framework is not meant to influence decisions over whether or not to engage in risky situations – these are taken on political grounds – but rather the way in which engagements are to be undertaken. It should also be noted that the Canadian START initiative (see Chapters 1 and 3) expects to be able to employ a tailored risk analysis framework (derived from the risk management framework of Canada's Treasury Board Secretariat).

Although not specifically referred to as risk analysis frameworks, increasingly country offices and/or embassies are regularly analysing the political-economy context. Such analysis in effect serves as a risk analysis and management instrument (*e.g.* the Dutch Strategic Governance and Stability Assessment Framework). It assists in the strategic management of programmes by alerting managers to changes in country conditions that may require adjustments to priorities or delivery methods; it supports operational management by identifying threats to the successful delivery of programmes (Box 2.2); and it enables donors to protect their staff and contractors by identifying threats in the operating environment (Cox and Thornton, 2010).

The Democratic Republic of Congo illustrates the problem of balancing the risks of planning jointly with host governments against the risks of *not* doing so. The international community has had limited influence on the DRC government, which adds to the operational challenges of planning, alignment and co-ordination. This lack of co-ordination has been highlighted by the activity of bilateral actors – like China – whose engagement in the DRC has been driven by political, strategic and economic interests (Jiang, 2009). DAC donors have attempted to address their weak influence on the government and their lack of co-ordination by jointly preparing a Country Assessment Framework[8] and an engagement strategy. However, the strategy,

critically, has not involved Congolese actors in the planning and negotiation phases. The risk that these priorities will not achieve political buy-in from DRC government stakeholders is consequently high – a dangerous precedent to be setting, given that, cumulatively, these donors supply 85% of official development assistance to the DRC (Cox and Thornton, 2010). However, the consensus appears to be that these risks are outweighed by those associated with closer engagement with the government.

Box 2.2. **Sida's risk assessment in the Democratic Republic of the Congo**

In order to monitor the situation in the Democratic Republic of the Congo (DRC), donors have devised a number of different strategies, including the articulation of a joint Country Assessment Framework. The related pooled mechanism is designed in part to transfer the risks of engagement and programming onto the UN, enabling bilateral donors to provide institutional aid without running the danger of all the associated risks of programming in fragile contexts. Where bilateral donors have decided to undertake bilateral programming as well, a number of innovations have been introduced, such as diagnostic systems. Sida, for instance, uses monitoring exercises to determine the drivers of risk for its programming in the DRC so that the agency can address rapidly changing conditions on the ground. To understand risk effectively, Sida examines power dynamics and uses a number of scenario-planning tools to identify the range of possible consequences of co-operation and programming (Sida, 2009).

Risk, results and realism: are they compatible?

With the current financial crisis and increased media attention on government spending, the pressure to show results from aid money has increased dramatically. It is now not uncommon for donor agencies and politicians to be held publicly accountable for any failure to achieve expected results or to spend taxpayers' money effectively and efficiently.

This is leading to more and more donors adopting "results-based risk assessment frameworks". This tendency is reflected in international aid policy frameworks, which have become increasingly focused on identifying results chains (input–output–outcome–impact); results-based management and reporting; and improving monitoring and evaluation systems as an integral part of results frameworks. For example, DFID's Results Action Plan (November 2007) stresses the importance of good results management in fragile states and calls for more quantified information on the impact of programmes (Cox and Thornton, 2010).

This focus on results has major consequences for donors' willingness to take risks: the pressure to show results appears to be making donors more risk-averse. This, in turn, makes implementing agencies also more risk-averse – they do not want to end up as scapegoats for the donor community. Two particular aspects of results-based management might be expected to influence the level of risk-taking in these circumstances. First, there would appear to be a structural incentive to avoid setting ambitious objectives or adopting new or untested approaches to programmes, as this might increase the chances of programme failure and make it harder to demonstrate results. Second, the system implies an ability to demonstrate results on an "outcome" and even "impact" level, but this is notoriously hard to do – particularly in fragile and conflict situations. There is reason to believe that both factors have tended to make for more cautious and risk-avoiding behaviour in the design of programmes, at least at the level of tangible outputs and outcomes. Logical frameworks focus the mind on what it will be possible to demonstrate.

In spite of these factors, there is a tendency to set highly ambitious "strategic" or "meta" objectives alongside more immediate goals, and a corresponding tolerance of failure to achieve such objectives – at least in the settings of highest strategic concern to donors. Indeed, practice shows that realistic objectives, coupled with appropriate timelines and commensurate resourcing, are the exception rather than the norm. As one Sida respondent observed:

> *You have to be able to see where things will go: trial and error. If there is a long-term engagement, then you have more time to right the wrongs. Unfortunately, the focus in transition situations is usually very short term. On the issue of realistic timelines: as it stands now, donors and agencies are playing a game of fiction – donors will not fund agencies that are using realistic timelines. So agencies work to timelines that they know are not realistic, and donors accept that. (Source: Interviews with Sida official)*

By way of example, a 2009 review of the World Food Programme's (WFP) strategy in the DRC noted that the WFP plan "… assumes things about capacities and the pace of government-led reform that now (and perhaps at the time) look highly over-optimistic. Perhaps this is what WFP thought its donors wanted to hear, but it raises serious questions about the kind of consensus that allows such propositions to become the basis for planning." (Darcy and Foliot, 2009).

It seems that the failure to achieve "meta-objectives" such as those related to peacebuilding or statebuilding – over which donors acknowledge they may have relatively little influence – is treated with a high degree of tolerance. Indeed, the risk of programme "failure" in this wider sense is

arguably built into many programmes from the start. While the more tangible and more easily-measured programme elements (such as food distribution or health care) are treated according to more normal rules of accountability, the intangible elements sometimes appear as window dressing. One of the key questions, therefore, is how to break down vague and over-ambitious objectives into more realistic and tangible goals that can be integrated into results management at the country and programme levels.

Related to this is the question of how objectives can be identified so that they acknowledge the risks involved. This requires a sound understanding of the sources and drivers of conflict and fragility. Programme documents need to (Cox and Thornton, 2010):

- Make risk drivers explicit, stating which of them the programme seeks to influence (taking into account the political opportunities that exist and what others are doing) and how the portfolio of interventions has been designed to accomplish this.
- Identify the risks involved.
- Justify why these risks are taken (including a trade-off/cost-benefit analysis).
- Explain how the programme will tackle the risk outcomes if they occur.

In practice, however, logical frameworks in situations of conflict and fragility tend to be over-ambitious and unrealistic. Risk assessment, if present at all, is mostly a "tick-box" exercise.

Monitoring risk

The three categories of contextual, programmatic and institutional risk (Box 1.1) can help donors distinguish the different levels of monitoring that are needed. Risks in the external environment are generally tracked at country level and must be factored into project management, while risks that are internal to the design and management of individual projects (*i.e.* programmatic and institutional risks) tend to be monitored and managed at the intervention level. As external risks are mostly beyond the control of donors, the focus is largely on programmatic and internal risks. In order to manage these, higher levels of operational monitoring are needed in these environments, for several reasons:

1. Implementing partners tend to be activity focused and to lack flexibility.

2. Interventions are harder to deliver in difficult operating environments, and implementing partners may struggle to post experienced managers to insecure environments.

3. Counterparts may be weak, and weak partners tend to be optimistic in their reporting.

4. Donor staff in the field can become used to working in risky environments and may not be attuned to gradual increases in the level of risk.

All of this calls for additional monitoring arrangements to give donors an accurate picture of implementation.

One of most basic challenges to monitoring the progress of a programme and the factors that may cause it to fail is data shortage in fragile or conflict-affected settings. National data systems may have broken down, in some cases for long periods of time, meaning that basic demographic data are not available. In countries with repressive regimes, in particular, government data may be politicised and unreliable. Security constraints may hamper access to many areas for data collection (Box 2.3; Cox and Thornton, 2010). Donors and implementing agencies are increasingly recognising that financial investment in generating information is not only appropriate, but essential.

Box 2.3. **Somalia and the problems of aid monitoring in highly insecure environments**

Somalia epitomises some of the external and internal risks involved in aid work in fragile states. Rampant insecurity, weak state structures and volatile politics add to a situation where aid workers have very little control and are often at great personal risk. Consequently, many international aid organisations have responded by removing most or all foreign personnel from the country and instead running "remote control" operations from Nairobi or other neighbouring countries. Aid organisations often contract out operations to local implementing partners instead of working through their own staff on the ground. However, while this avoids the security risk to their own staff, it also drastically undercuts these organisations´ oversight and control of their operations. For instance, the US government has a policy of no presence on the ground in Somalia, so USAID relies on information from partners, other donors, local officials, news reports and other key sources of information to plan and monitor its programmes (US Accountability Office, 2008).

Box 2.3. Somalia and the problems of aid monitoring in highly insecure environments *(continued)*

This kind of operational outsourcing can have serious consequences, as WFP found in Somalia (see Chapter 3). In the absence of proper monitoring mechanisms, aid may be diverted to enrich contractors or even fund armed groups, rather than supporting the needy populations for which it is intended. Even where there is no large-scale graft, local contractors are often able to negotiate extortionate fees for their services as a result of the absence of competition and the pressing need for service delivery. This illustrates some of the most painful dilemmas of working in fragile states. Responding to the security risks of operating in the country by pulling out staff inevitably increases programme and fiduciary risks. Besides the dangers of actually causing harm, organisations risk damage to their reputations in these circumstances.

The issue is not confined to Somalia. For example, a number of major NGOs reported that donors were not prepared to fund them in Iraq in the mid-2000s because the donors had little or no ground presence, were working through intermediaries, and could not provide the requested guarantees on reporting and accountability (ODI, 2008).

2.3. Bridging differences in risk perceptions and tolerance

Over the last couple of years the international community has increasingly recognised that engagement in fragile and conflict-affected situations requires multiple actors to work together in a coherent manner. This is very clearly reflected in the FSP (Box 1.5), which state that "… the particularly complex and severe development challenges that the international community is confronted with in fragile situations require joined up and coherent action by political, economic, security and development actors within and among governments and organisations" (OECD, 2007). These spheres are considered to be interdependent: failure in one risks failure in all others.

By identifying the rationale for coherent working, the OECD believes it will reduce the risk of objectives either being compromised or simply not being met (*i.e.* programme risk; OECD, 2006). However, the fact that so many different actors are involved in a process also *creates* risks, as it makes it difficult to align different approaches and objectives within one strategy. This applies both to the process of developing a risk management strategy and that of developing an overall intervention strategy.

The process of assessing and analysing risks, and then developing a strategy to manage these risks, is currently something of a tacit compact

among all the different stakeholders involved – if it happens at all. Yet in order to be as effective as possible, a joint strategy needs to build on the comparative advantages of all the actors involved (Box 2.4). There is also a need to better align risk perceptions: what is a risk to one is not necessarily a risk to another (and may even be an opportunity). As an example, one respondent pointed to the fact that the World Bank is about to provide substantial funding to the DRC Government for mineral extraction. The risk calculus for this intervention may be very different depending on where you are sitting. Some would perceive the chance of doing harm through such an intervention as being too great, while for others, this intervention is justified by the countervailing risk of *not* investing and thus failing to boost the control of the DRC government over mineral extraction in the country.

We often willingly take risks because we see the *prospect of future gain*. Given our limited ability to predict the future, even where we have some influence over it, any investment in an enterprise carries some degree of risk. That risk increases in fragile states, where the number of variables (and hence the degree of uncertainty) tends to be high, and the degree of control low. But the stakes are commensurately high, whether expressed as contextual risks averted or positive outcomes achieved. By not being willing to take risks, we forego the opportunity for gain. One of the problems considered below is the generic problem of defining "gain" (or success) in both the development context and that of wider foreign policy goals.

Box 2.4. **Shared risk analysis: a US example**

Any intervention in fragile and conflict-affected situations is a process of linking the political reality in-country with donors' domestic political realities. It requires a constant reviewing of the risks involved and the level of exposure. Many donors have developed analytical instruments for this purpose. One example is the US Inter-Agency Conflict Assessment Framework, a tool that brings together experts to develop shared analysis. The tool is generally administered by the State Department and USAID with the participation of other relevant agencies. The shared analysis allows for greater transparency, at least internally, on the rationale for interventions. This is perceived to be very important, as the rationales for engaging in fragile and conflict-affected situations may differ and at times conflict. Actors approach the work from different angles, ranging from counter-terrorism to governance, conflict prevention and peacebuilding, trade promotion, and development co-operation (OECD, 2006). These differences in rationale lead to different assessments of the risks involved.

It is important to understand that risk is a *relative* (not an absolute) concept: we need to understand from whose perspective a risk judgement is being made. In some cases, the same outcome or event may be good for one party and bad for another. For example, if a gambler places a bet on a horse to win a race and it wins, this is good for the gambler and bad for the bookmaker (and *vice versa* if the horse loses, which it usually does). This risk/gain *reciprocity* is a common, but not universal, feature of risk: one party may gain from the very thing that causes harm to another. More often, perhaps, an outcome that is undesirable to one party may be a matter of no particular concern to another – and perhaps even a matter of complete indifference. Either way, incentives to ensure or avoid a particular outcome can be very different, depending on whose perspective is considered.

Understanding risk and the part it plays in people's own decisions and behaviour is an essential part of successful engagement in fragile states. In particular, it is crucial to understand the nature of contextual risk and the different perceptions of it. For example, the greatest risk as perceived by the international community (*e.g.* the political resurgence of the Taliban in Afghanistan) may not be the same for ordinary people (who may be more concerned about ongoing threats to their own security and freedom of action). The questions of how ordinary people's decisions are informed and what motivates their behaviour are important considerations for those planning to intervene on their behalf. In other words, *perceptions* of risk are important here, and we consider this below in relation to both institutions and individuals.

This point is not confined to "contextual" risk as defined above. Institutional risks are likely to be perceived differently by different parts of the same institution and individuals within it. Similarly, programmatic risk – the risk of programme failure – may be seen differently in the field and at headquarters, or by different government departments. It may also be seen differently by donors, implementing agencies and aid recipients. So, for example, while donors may be most concerned with failed investment (wasted money), agencies may be more concerned with the loss of their reputation, either with the donor or with the community or host authorities. For the intended beneficiaries, on the other hand, programmatic failure may be a matter of life and death – or at the very least may have significant implications for their chances of effective recovery.

One important aspect of aid interventions is an asymmetry in risk taking and risk perception that can result from weak local ownership. In such situations, donors may in effect take risks "on behalf of" the recipient country. This can affect both donors' and recipients' perception of risk, and donors may be less risk-averse if risks are shared more equally by recipient countries. Another question of risk balance arises between bilateral donors and the multilateral organisations through which they channel assistance. In the following sections, we consider in particular the issues associated with

multi-donor trust funds and other pooled funding mechanisms, in which programme and institutional risks are both transferred and shared.

When understanding different risk perceptions, it is important to take into account the different levels of *risk tolerance* among different actors. Risk tolerance is made up of two things: *(1)* risk appetite; and *(2)* the capacity to take on risk (*i.e.* to assess and manage it). A large organisation like the WFP, for example, is better able to deal with risk – and so can better cope with a crisis like the current one related to food aid in Somalia – than a small NGO.

Understanding how risk tolerance varies

One of the greatest challenges in adopting a whole-of-government approach is to bridge differences in organisational cultures. This section explores the ways in which risk is perceived by different sectors.

The culture of risk

Organisational culture can be described as "a pattern of basic assumptions that are invented, discovered or developed to help cope with problems of external adaptation and internal integration within an organisation" (Schein, 1991). The pattern of assumptions may include values, norms, rules, myths, stories and rituals. An organisation's culture arises from a number of factors, including the predispositions of members and the circumstances with which the organisation must cope. Rather than one culture, many organisations have several cultures that are often in conflict (Box 2.5).

An organisation with a strong sense of mission may excel at carrying out tasks defined within that culture, but is likely to be poorly adapted to perform tasks that are not defined as part of that culture. This is relevant in fragile and transitional settings, where both donor departments and their partner agencies may be operating outside their "comfort zones" and where organisational culture may make adaptation difficult.

In terms of risk-taking, one can also see cultural differences. Departments for development co-operation are traditionally more process oriented, whereas defence or foreign affairs departments tend to be more output oriented (OECD, 2006). Several respondents referred to the fact that defence and foreign affairs departments are used to taking calculated risks – *e.g.* in deciding whether or not to engage in a military intervention. Development actors, on the other hand, are perceived by some as living in a technocratic bubble, developing technical solutions to highly political problems, setting unrealistic timelines for achieving results due to mounting political pressure, and understating the risks involved in engaging in fragile and conflict-affected situations. Respondents referred to the fact that the relevant literature on intervening

in fragile states suggests that (on average) there is at best a 50% chance that an intervention will be successful. Moreover, what counts as "successful" in aid delivery terms is often narrowly interpreted, so that anything short of a 100% achievement of objectives is considered to be a failure. One respondent described how a donor had provided funds to set up 10 women-only projects in Afghanistan. The programme was scored and listed as "unsuccessful" because it only managed to establish 8 projects instead of 10. As noted above, what constitutes success depends on your point of view, but this example surely points to a problem of perceiving and evaluating "success" in difficult working environments.

Many respondents feel that their respective departments for development co-operation remain too "traditional" in the sense that the focus is on supporting development only in terms of economic growth, health and education.[9] Risk taking and involvement in political processes are not mandated from the top. This partly has to do with the fact that in most countries, development co-operation is the least powerful actor in the 3D package (defence, diplomacy, development).

Risk management systems must not only consider the "hard" aspects of procedures and systems, but also "soft" aspects such as behaviour, organisational culture and incentives (See Box 2.5).

Box 2.5. **System-wide cultures**

Sometimes the culture "problem" goes beyond the bounds of the individual organisation and extends to the way in which a whole government thinks. In a recent paper, Andrew Natsios, former USAID administrator, has written about the dominant "measurement" culture in the US public sector and the way it affects the delivery of international development assistance:

> *One of the little understood, but most powerful and disruptive tensions in established aid agencies lies in the clash between the compliance side of aid programs – the counter-bureaucracy – and the technical, programmatic side. The essential balance between these two in development programs has now been skewed to such a degree in the U.S. aid system (and in the World Bank as well) that the imbalance threatens program integrity. The counter-bureaucracy ignores a central principle of development theory – that those development programs that are most precisely and easily measured are the least transformational, and those programs that are most transformational are the least measurable. Relieving the tension between the counter-bureaucracy and development practice would require implementing new measurement systems, conducting more research on overregulation and its effects, reducing the layers of oversight and regulation, and aligning programmatic goals with organizational incentives. (Natsios, 2010)*

Humanitarian versus development perceptions of risk

It is generally felt that humanitarian actors are less risk-averse than development actors, largely because donors are more tolerant of risk-taking and failure to fully account for the use of funds in humanitarian programmes. Humanitarian assistance is also felt to carry less political risk, particularly when it is delivered through international agencies. Development assistance is felt to be ill-suited to financing transition activities: it is seen as inflexible, bound too closely to the idea of government-led initiatives and requiring responsible governance and the capacity to deliver. These requirements are unwarranted in the immediate aftermath of conflict – the contextual risks are simply too high and the needs too urgent. As a result, donors tend to prefer humanitarian instruments in protracted crises, but do not generally allow recovery-type activities to be carried out with such funding (Beijnum and Kaput, 2009).

Integrated versus independent development co-operation institutions

The research shows there is a difference in assessing and managing risks between those donor governments that have integrated development co-operation within their department of foreign affairs and those that have an independent department for development co-operation. In the cases of Denmark and the Netherlands, for instance, their respective MFAs deal with both political and security issues as well as development co-operation. Here the conduct of risk assessments and analysis is a shared process, and the level of exposure is the same for all elements, because they are all part of the same organisation. As a result, battles are fought internally and not in public. In countries like Sweden, the UK and the US, on the other hand, there have been cases where development co-operation is felt to have been "hung out to dry" after an intervention had gone wrong, while the foreign affairs departments remained out of sight. Specifically, respondents referred to the need for government to have "plausible deniability". The fact that Sida in Sweden, for instance, has a high degree of independence and autonomy means, on the one hand, that it is harder for the Swedish government to "steer" it; but, on the other hand, if something goes wrong, the MFA can say that Sida handled the intervention on its own. As a result, some respondents felt that Sida staff were becoming more risk-averse, as they feel the political cover to take risks is lacking.

Headquarters versus in-country perceptions

Differences exist between risk perceptions at headquarters and in the field. This is especially relevant where donors have decentralised their development aid so that it is embassy staff, and ultimately the ambassador,

who take decisions about taking risks. In general, it is felt that headquarters tend to be more risk-averse than staff in the field. So the fact that most corporate tools used to analyse and assess risk are developed by headquarters means that these tools do not necessarily fit the reality on the ground. Many respondents noted the need for headquarters to double check assessments made at field level: people that have been in the field for a long time start judging risks in a different way – they are more used to threats and risks and therefore tend to grow more tolerant of them.[10] There is also a tendency to validate "sunk costs" by continuing to pursue an approach beyond the point at which it appears to have failed (see Box 2.6).

Box 2.6. **Risk psychology and individuals' risk behaviour**

Risk management systems must not only consider the "hard" aspects of procedures and systems, but also "soft" aspects such as behaviour, organisational culture and incentives.

When faced with complex problems or incomplete information, rather than undertake taxing calculations, people tend to resort to simple educated guesses, "rule-of-thumb" thinking or personal intuition. Psychologists refer to these as "heuristics" (*e.g.* Gilovich *et al.*, 2002) or "biases". These tend to shape individual decision making about risk taking in significant ways.

The "sunk cost" fallacy is one of the most troubling biases, where people fail to cut their losses and continue investing in clearly failing situations. This suggests that people who have invested time and money in something may have a strong tendency to continue to invest despite clear losses. As Teger (1980) suggests, people can find themselves with "too much invested to quit" and are reluctant to waste their effort. More generally, losses "weigh" more heavily with people than gains. "Prospect theory" posits that individuals are much more distressed by prospective losses than they are made happy by equivalent gains. (Kahneman & Tversky, 1979)

Risk processing and response are highly affected by personality traits. One such trait is the individual's "need for achievement" (McClelland, 1967). People who have a strong need for achievement tend to avoid both low-risk and high-risk situations. They avoid low-risk situations because it is easy to be successful in them and so a genuine sense of achievement is lacking. They avoid high-risk situations because they may not be successful and therefore will not gain the positive feedback they desire; or else the outcome could be attributed to chance rather than their own efforts.

Many of the implementing agencies consulted for this study felt that their field actors were under enormous pressure from incentives *not* to take risks. This feeling has been strengthened by the decentralisation of development co-operation: country offices are protecting their budgets and their "business as usual". Meanwhile, at the central level, the focus is very much on preventing reputational damage, with headquarters perceived to be protecting field activities from outside criticism.

Implementors versus auditors' perceptions of risk

There is a clear difference in risk perception between those involved in implementing development activities, and those involved in controlling and accounting for them. Due to an increasing pressure to account for public expenditure and a growing intolerance of corruption, financial and administrative regulations seem to have become the most important parameters against which to assess risk. This emphasis on limiting fiduciary risks has made development actors more risk averse. In the case of Sweden, for instance, Sida has been publicly attacked in some very critical audits in which the auditors found that the paper trail for certain activities was not up to standard. As a result, Sida now has a zero tolerance approach towards corruption. Along the same lines, in Denmark it is now mandatory to report all cases of corruption on the Internet so that the public can see what is happening, how much money was involved, and so on. This is a response to events that took place in the summer of 2008, when the Danish Minister for Development Co-operation was publicly criticised for not telling the auditor-general about certain cases of corruption.

In the US, the management of foreign aid is also very restricted by the influence of risk-averse auditors and controllers. The Office of the Inspector-General, responsible for investigating all foreign assistance using public funds, has no tolerance for anything less than full accountability. The same applies to the US Accountability Office, the investigative office for Congress. The result is that aid agencies spend a lot of time meeting these institutions' requirements rather than focusing on the development issues at stake. Organisations become more risk-averse as a result.

The difference in risk perception between those implementing programmes and those accounting for and controlling them also occurs between donors and implementing organisations like the UN and international NGOs. According to most of the implementing organisations consulted for this study, the regulations imposed by the donors in an effort to reduce fiduciary and programmatic risks restrict their room for manoeuvre, decreasing both the efficiency and effectiveness of their interventions. The same applies to the level of control required by donors in an attempt to avoid programmatic risks (*e.g.* reporting requirements and decision-making processes). Another point is that the

objectives identified by donors, and for which they hold implementing agencies to account, can be unrealistic in most fragile states. A good example is the Millennium Development Goals.

Many respondents stated that donors in effect transfer risks to their implementing partners, sometimes using them as scapegoats if a programme fails. This in itself is not necessarily a bad thing, as these organisations – and specifically UN agencies – are in some respects better suited to intervene in fragile and transitional situations based on their mandate, financial weight, capacity to engage in a direct and neutral dialogue with host governments, and political influence. However, it is essential that bilateral donors realise that the transfer of risks to these organisations does not mean that they have transferred all responsibilities for risk taking. Respondents stressed the need for donors to provide the political backing necessary for the implementing agencies to take risks. A review of multi-donor trust funds conducted by the World Bank shows that although trust funds pool risks for donors and implementing partners, as fund manager, the World Bank is taking substantially more risk than the donors (World Bank, 2010). This has resulted in bank staff becoming more and more risk averse.[11]

Bilateral versus multilateral funding risk perceptions

Respondents pointed out that the tolerance of failure among donors is higher for bilateral funding than for multilateral funding. At the same time, some UN agencies and the World Bank are less accepting of failure than bilateral donors, largely as a result of extensive donor criticism. The UN Development Programme (UNDP), for instance, is still haunted by the Iraq oil-for-food debacle. Our study has highlighted a miscommunication between implementing agencies and donors: each tends to make assumptions about the other. Specifically, implementing agencies think donors have certain limits (in terms of money and procedures), while in reality donors may be more flexible. Open communication is the key here: most often donors say they are willing to make adjustments or exceptions to rules and regulations, provided that this is supported by valid arguments and evidence.

Civil servants' versus politicians' risk perceptions

Increasingly, civil servants are caught in a political struggle as politicians focus more and more on foreign agendas to allow them to claim the credit for good results. Risk management strategies need to take into account to what extent civil servants are being honest in their reporting to political decision makers. Politicians wish to have speedy results and no embarrassment; civil servants need to counterbalance this and be honest about timelines and obstacles to achieving objectives. Experience shows that in order to take a

calculated political risk, strong parliamentary backing is required. For obvious reasons, there is a higher political willingness to take risks when a country's own interests are at stake. For instance, if donor countries have troops involved – *e.g.* Danish soldiers in Afghanistan's Helmand Province – more innovative and high-risk activities are condoned. In such cases, political parties are often tied into the decision-making process. Getting buy-in from parliament is perceived to be a good way of managing risk. The Government of Canada developed public benchmarks and indicators for its engagement in Afghanistan, and provided quarterly reports to parliament on progress and the challenges at play in the operating environment. This form of risk management enabled the government to improve communications with the public and parliamentarians on what it was trying to achieve in Afghanistan, and to clarify why it might not achieve objectives in certain areas due to circumstances on the ground.[12]

Summary: handling differences in risk perceptions

In an ideal world, one should take into account the different risk perceptions of all international actors when formulating strategies, because responding to contextual risk should be a collective agenda. However, the research for this study has revealed that collective risk perception is rare – the focus is very much on individual organisations. That said, there are some positive examples of collective approaches where less risk-averse donors have started a project and more risk-averse donors have been able to step in at a later stage (when some of the perceived risks had been reduced). Denmark, for instance, has piloted projects on SSR in Zimbabwe that have later brought in the UK and other like-minded donors. The same principle may hold true across government departments, or even across departments within donor bodies, depending on their remit.

An organisation's level of risk-taking depends on institutional backing and incentives. One has to take into account not only the institutional risk faced by the organisation, but also the risks involved for the person who decides to take or accept certain risks. What are the consequences for this person's career if things go wrong? Is there institutional backing for him/her? An organisational culture that encourages and rewards appropriate risk-taking is needed, yet few donor bodies or implementing agencies currently offer their staff incentives to take risks. Even though in many cases – like Sweden, Denmark, the Netherlands, Canada, the UK and the World Bank – the official line is that staff are encouraged to take calculated risks, this has not been incorporated into the operational system. If you take a risk and the outcome is successful, there is no problem (although the success may not be recognised). But if the outcome is an obvious failure, there is no institutional support and no policy or explicit *political* cover. Many respondents stated that in these circumstances, staff's level of risk-taking was influenced by the level of experience they have

of the system – the more a staff member knows and understands the rules of the game, the more willing he/she is to take risks. Crucial to this is the lead given by senior managers, and the extent to which they are prepared to support those who take appropriate risks and manage these risks properly, even when the outcome may be adverse.

Establishing an appropriate risk culture – one that encourages appropriate risk taking while having adequate controls in place to avoid over-exposure to risk – is an essential task for managers whose job includes overseeing engagement in fragile and transitional contexts. Because so many organisations and mandates are involved, it is hard to generalise about this. But based on consultations for this study and a review of the literature, building an appropriate risk culture seems to require a number of elements:

- A defined structure/oversight system within which risk can be managed, allowing relevant decisions to be delegated or taken by senior management, as appropriate. This may require the pre-agreement of an organisation's board or a government department's minister that defines limits above which their explicit approval is required. "Bottom lines" can be defined, but should not be so restrictive as to inhibit appropriate action.
- A system of regular institutional risk review, and a culture of open and regular discussion of institutional risks between line managers and their staff.
- Incentives for appropriate risk taking, while removing disincentives. This might include providing political/institutional "cover" for those making risky decisions.

A similar culture needs to be fostered between donors and their implementing partners.

Notes

1. Interview with Danish MFA official, 5 March 2010.
2. Interview with Sida officials, 10 February 2010.
3. Interview with Danish government official, 5 March 2010.
4. Interview with EU official for this study.

5. In the terms used in this study, these would be considered risk *factors* that might contribute to the risk of programme failure.

6. Again, in the terms of this study, these are a combination of risk factors and institutional risks.

7. Interview with Canadian government officials, 19 April 2010.

8. At the time of its completion, 17 partners were involved in the Country Assessment Framework, including the World Bank Group, the UN system, the European Commission, the International Monetary Fund and the African Development Bank, as well as key bilateral donors.

9. As Andrew Natsios (2010) argues in the case of USAID, this is partly because of a tendency to focus on what can be measured – a direct response to public accountability pressures.

10. What Jared Diamond (2005) calls "creeping normalcy"; otherwise known as the "frog-in-the-pot" syndrome.

11. Interview with World Bank representatives, 15 April 2010.

12. Interview with START officials, July 2010.

Chapter 3

Approaches to managing risk in fragile states

Chapter 3 reviews current approaches to risk management in fragile and transitional contexts. It looks first at institutional approaches, including several case studies of donors that have set up specialised units to operate in contexts where standard development approaches would be too limiting. It finds that specialised units like these can provide leadership and a responsibility focal point for more risky activities. They can also keep the public and political decision makers informed about progress and set-backs on a very regular basis, so as to create buy-in.

The chapter then moves on to consider the two most important kinds of aid in fragile situations: financial support and technical assistance. It finds that transition financing mechanisms are needed that enable flexible and rapid responses to a wide variety of needs and opportunities and reviews the different types of funding arrangements that are possible. These include funds set up especially for fragile situations; pooled funding arrangements that help donors share and spread their risks; and budget support so that donors can align their efforts with existing partner country mechanisms.

3.1 Institutional approaches to risk management

Organisation and system-wide approaches

As discussed in Chapter 2, many donors and aid agencies do not have specific frameworks for assessing and managing risks in fragile states, but instead use general project and programme management frameworks for all forms of development co-operation. Interestingly, in those cases where we encountered risk management frameworks, these were essentially corporate risk frameworks concerned with identifying and avoiding or minimising institutional risks – in other words, the organisation's own exposure to harm. While programme risk is sometimes included in these kinds of frameworks, programme failure tends to be seen in terms of reputation and financial accountability. While there is high acceptance of programmes and interventions not reaching their objectives, there is virtually no acceptance of financial resources being misused or funds being unaccounted for. Almost all those interviewed for this study, from UN agencies to bilateral donors, indicated that such misuse of financial resources and the consequent damage to their own organisations were "bottom line" risk outcomes – *i.e.* what they could not afford to have happen.

Linked to this focus on institutional risks, the aid community (*e.g.* bilateral donors like Canada and Sweden, as well as an increasing number of UN agencies like UNDP and WFP) is increasingly drawing on the risk management systems and management theories from the commercial sector, such as enterprise risk management (ERM; see Chapter 4). In practice, this means ensuring organisation-wide risk management by establishing clear lines of management and governance responsibility; processes for identifying and monitoring key risks for the organisation concerned; and data and analysis tools for monitoring and evaluating these risks.

One difficulty with applying ERM approaches to the aid sector in general and interventions in fragile states in particular is that in most cases there is no clearly identified and agreed overall objective against which to measure success. Unlike the commercial sector, there is no one measure like "profit" or "loss". The various actors and agendas involved – political, military, developmental – each have their own approaches and criteria for success and failure, risk and opportunity (see Chapter 2). This in turn makes it difficult to establish an organisation-wide system of risk management and clear lines of responsibility. The leadership issue is worth restating here: there is a clear need for consistent leadership at all levels that is willing to take risks and try something new in order to ensure effective interventions in fragile situations.

The fact that the systems developed by Canada and Sweden are not specifically geared towards fragile states may in certain circumstances create problems, specifically in terms of enabling the speed and flexibility of interventions – key elements of success in such situations. Increasingly,

aid actors are developing special instruments, with rules and regulations that differ from those of interventions in "normal" development situations (see Section 3.3 for examples). Having an organisation-wide system in place could undermine the possibilities of making exceptions for certain kinds of situations – having to go through the "normal" process will in most cases be too time consuming. CIDA, however, feels that its pre-established system has built-in flexibilities that can allow it to react in a timely fashion.

UN agencies face an extra difficulty in working to a system-wide risk management approach. Even though a system-wide process of UN reform is under way, individual UN agencies have their own risk management frameworks. With the increase in joint programming, there is a commensurate increase in joint risk assessments and joint risk management efforts (Box 3.1). However, there is no UN-wide leadership on this issue. The UN Development Operations Co-ordination Office (UN DOCO) is starting to explore options for getting involved in this process and the subject was discussed in the High-Level Committee on Management. Efforts are also being made at field level.

Box 3.1. **Joint UN risk management approach in Somalia**

In 2009, the UN Resident Co-ordinator (RC) for Somalia found himself confronted with a situation where more money was being allocated to assist the country, but where fewer UN staff were present in-country to manage and control the interventions. The RC requested input from all relevant heads of agencies and headquarters on risk assessment and identifying a risk management approach. A headquarters mission was put together, co-ordinated by UN DOCO and consisting of representatives from the UN Children's Fund, the UN Office for Project Services, WFP and UNDP, to go to Nairobi on a three-week mission to map all the risks identified by the different agencies. They subsequently prioritised these risks and identified the potential impact if they occurred. They also provided the RC and the UN Country Team with suggestions on how to mitigate the risks – focusing specifically on security issues, partner selection (and due diligence), how to deal with remote programming, and how to work on perception management.

One of the recommendations was to set up a risk management team within the UN Country Team; the RC in turn dedicated one staff member in each agency (both at headquarters and field level) to focus on risk-management issues and co-operate with the risk management team.

Source: Interview with UN DOCO representatives, 2 February 2010.

Risk management at programming level

As most donors do not have overall risk management guidelines for fragile and conflict situations, risk management is becoming increasingly structured at the programming level. DFID Country Offices, for instance, are developing risk registers which are increasingly becoming an integral part of managing a country programme. These identify risks, their severity and likelihood, factors that may trigger them or indicators to show when they are occurring, mitigating strategies and contingency plans (Cox and Thornton, 2010).

In a recent evaluation of its country programme, DFID's approach to addressing the risk factors in Nepal's conflict/post-conflict environment was singled out as a model for good practice (Box 3.2). The example shows how a donor's ability to address risk evolves over the period of engagement in a country, and how monitoring tools and analysis enabled work to remain relevant and effective despite volatile political conditions. It also shows how the efforts of one donor can provide opportunities for other aid actors, as

Box 3.2. **DFID's approach to risk management in Nepal**

DFID's risk management strategy in Nepal is built around two key elements: *assessments* and *instruments*. A number of assessments were done, both independently and jointly with other donors in Nepal, to identify potentially problematic areas. These included fiduciary risk assessments undertaken together with the World Bank and the International Monetary Fund; and risk assessments in key sectors such as health. Although these assessments noted strong technical capacity in the country, a number of other issues – such as the government drawing on donor funds for security-related expenditure – prevented DFID from moving towards wider general budget support beyond health and education.

In response to information from these assessments, DFID took a number of steps to ensure the safety of its staff and safeguard its programming in Nepal. In 2002, DFID and GIZ jointly established a Risk Management Office (RMO) to provide advice and training on risk management for staff. It also supplies agencies with qualitative security information gathered from across Nepal. The RMO has been effective in providing detailed security analysis and ongoing context assessment, including future scenario mapping for DFID and implementing partners. Furthermore, DFID also developed and implemented Basic Operating Guidelines. This set of 14 principles of engagement allow common approaches to programme management while remaining independent of forces involved in armed conflict in the country. These guidelines were so well received that they have been endorsed by 11 bilateral agencies, international NGOs and the UN.

Source: DFID (2007).

many of DFID's efforts in Nepal were carried out in co-operation with others (other bilateral donors and the *Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH* [GIZ][1]).

Specialised units

Some donors have set up specialised units in headquarters to deal specifically with fragile and conflict-affected situations. These units provide central backing to country-level risk management approaches. They are often placed somewhat outside of the normal bureaucratic structures and report directly to the political leadership. These units bring together the required expertise from the different relevant fields (security, governance and socio-economic development) and most of them have their own funds, so as to ensure flexible and rapid responses.

Among the first bilateral donors to set up such specialised units were the UK (the Post-Conflict Reconstruction Unit) and the US (the Office of Transition Initiatives – OTI; Box 3.3).

Box 3.3. **New rules of engagement: the US Office of Transition Initiatives**

The OTI was established by USAID specifically to deal with risk issues – *i.e.* to operate in contexts where standard development approaches would be too limiting. The OTI aims to support US foreign policy objectives by helping local partners advance peace and democracy in priority countries in crisis (although this is limited mostly to countries important to US national interests).[2] OTI programmes are often initiated in fragile states that are not yet stable enough for longer-term development programmes. The OTI has a distinctive way of operating:

- It specifically encourages a culture of risk taking, political orientation and swift response among its staff and partners. This culture is reflected in a strategic approach that continually incorporates best practice and lessons learned.
- It is funded by a separate transition initiatives budget account with special authority for immediate spending where it is most needed.
- It has created an innovative contracting mechanism that preserves the principle of competition while allowing quick start-up in new countries and the payment of direct grants to small, indigenous organisations.
- It has political sanction by Congress to work in specifically difficult contexts. Furthermore, it follows slightly different rules than the rest of USAID, seeking Congressional approval on a case-by-case basis (through waivers), *e.g.* for working with certain religious bodies.

Source: www.usaid.gov/our_work/cross-cutting_programs/transition_initiatives/aboutoti.html, accessed 28 May 2011.

Another example is the Dutch Peacebuilding and Stabilisation Unit in the MFA, which is responsible for policy formulation and implementation for fragile and conflict-affected situations. Two key elements enable the unit to act quickly and take risks if necessary: *(1)* it has direct access to its own central funds – the Stability Fund containing ODA and non-ODA funds and the Reconstruction Central Fund; and *(2)* a fragile states strategy supported politically and backed by parliament. As such, the unit is set up to ring-fence the risks involved with engaging in fragile and conflict-affected situations.

Along the same lines, Denmark has set up a Department of Stabilisation in its MFA and a central fund to support stabilisation processes, fed by the ministries of development, foreign affairs and defence. Besides having this specialised unit within the MFA, Denmark has also set up a task team for its most pressing engagement in a fragile and conflict-affected situation: Afghanistan. Because Danish troops are deployed in that country, this case has the highest political priority and, as such, from a risk management perspective, requires the involvement of and buy-in from the broadest group of actors. The Afghanistan Task Team consists of representatives of the different elements of the MFA (development, security, political), the Department of Defence and other relevant ministries. Representatives of civil society and the private sector are also closely involved, as is a special group in parliament. This allows for joint risk assessment and the development of a joint risk management strategy. It also allows the task team to make exceptions to the general rules and regulations, as all relevant political decision makers are involved in the process, which can allow for a less risk-averse approach.

The Canadian Stabilization and Reconstruction Task Force (START) was established in 2005 to enhance the Canadian government's ability to produce timely and co-ordinated responses to international crises and to act as a catalyst for whole-of-government humanitarian, stabilisation and reconstruction efforts. Because it is an inter-departmental mechanism, it brings together partner departments and agencies from across the Government of Canada. Like the other specialised units described above, START also has direct access to a dedicated fund: the Global Peace and Security Fund (GPSF). This fund is used to deliver peace and security initiatives that support Canadian foreign policy objectives in areas like conflict prevention, global peace support operations and SSR. While the Department of Foreign Affairs and International Trade is accountable for administering the fund, financial resources are drawn from the government's International Assistance Envelope, and the fund's activities are regularly reviewed by a whole-of-government START Advisory Board. In managing the Fund, START officials report that they encounter tension between the need to be risk-tolerant (the rationale for START to be created in the first place) and the expectations of impact and demonstrable or visible results. One positive aspect has been the flexibility it has given to Canadian aid interventions and engagement in Afghanistan. This was due to

an unusually high level of delegated spending authority and a very high level of infrastructural support, as well as extensive technical monitoring capacity. This again underlines the fact that a high level of vested political interest increases the willingness of (political) actors to allow for risk taking and to provide the necessary support to mitigate these risks as far as possible. Key in all of this is to keep the public and political decision makers informed about progress and set-backs on a very regular basis, so as to create buy-in. Having a specialised unit like START in place can play a vital role in such a risk management strategy, as it can provide leadership and a responsibility centre for such activities.

One final example is the World Bank Fragile and Conflict-Affected Countries Group (OPCFC). One of the bank's six strategic themes is to address the special problems of fragile states. The OPCFC co-ordinates the bank's response to these states and seeks to improve the effectiveness of development aid in these countries. The unit develops and implements the World Bank's agenda on conflict and fragility across the organisation. As such, the OPCFC serves as the corporate focal point, while other networks and regions in the bank support the fragile and conflict-affected countries' agendas through dedicated work programmes in their specialised areas. The OPCFC also manages the State and Peacebuilding Fund (SPF), which addresses the governance and peacebuilding needs of fragile and conflicted-affected situations. However, while all the systems for engaging in fragile states seem to be in place at the institutional level, respondents noted that the call for calculated risk-taking is not translated into the OPCFC's (internal) operational structures. Thus while staff are encouraged to take risks, unlike the example of the OTI (Box 3.3), there is no (political) cover for staff if an initiative fails.

Portfolio approaches to risk management

Internationally, there is a growing view that the most effective way to manage risks in fragile and conflict-affected situations is to take a "portfolio approach" to risk management. This means developing a balanced portfolio in each country that includes a range of interventions with different levels of risk and return (Box 3.4). It is easier to accept one high-risk, innovative project as part of an aid portfolio that otherwise consists of fairly low-risk standardised programmes. In such cases, the donor will have enough "return on its investment" from the standardised programmes to allow for the possible failure of the innovative project. This is analogous to the principle of diversification familiar to fund managers in the private financial sector. Risk can essentially be spread by varying the different types of intervention, aid approaches and instruments, and the channels used for aid delivery (implementing partners).

Box 3.4. **How DFID balances aid risks in the DRC**

The influence of the Paris Declaration agenda (Box 1.5) is encouraging donors to use national systems and processes. As part of this, donors to the Democratic Republic of Congo (DRC) have also begun building the capacity of national public financial management systems. This is particularly important, because the lack of adequate public financial management in DRC has meant that there is considerable risk of financial mismanagement and diversion of donor funds, low absorptive capacity, and weak overall government capacity. DFID has addressed these risks through a two-track approach: *(1)* a high-risk project to work through government systems to introduce cash transfers to reduce school fees; and *(2)* balancing these risks in another sector by avoiding government systems by working through trusted NGO partners to deliver health services.

Source: DFID, 2008.

As mentioned before, development in fragile situations is increasingly seen by donor governments in a wider foreign policy context. In this setting there are three strands to aid interventions: financial support and technical assistance, backed by political engagement. Political engagement might either be visible or invisible ("silent diplomacy"). While it is difficult to assess the level of risk involved with invisible diplomacy, there is little risk of political or reputational damage – unless there is a leak. More public political interventions tend to be made through the declarations of international bodies like the UN General Assembly, the Security Council or the organs of the EU. In this way, governments pool both the risks of failure and reputational damage. Of course, some donor governments carry out political interventions without having the protection of international bodies. Normally, this kind of risk taking is reserved for the most powerful states, or those that have most influence (*e.g.* in the case of former colonies or large trading partners). Such "champions of change" can take the lead, creating the opportunity for other donor governments to follow suit once the most immediate risks have been mitigated.

In the next two sections we consider the two most important kinds of aid in fragile situations respectively: financial support and technical assistance.

3.2. Financing in risky settings

Reflecting the growing popularity of the portfolio approach to risk management, a recent OECD INCAF report on transition financing shows that donors use a mix of budget lines and funding methods to finance

transition activities in fragile and conflict-affected situations (OECD, 2010). In such situations, methods need to deal flexibly with the many needs and opportunities as they arise. Yet donor co-ordination is often weak and development funding is rarely fast or flexible. It has also proved difficult to fund key activities – such as security sector reform – that do not fit the definition of ODA.

Given this inflexibility, donors have increasingly turned to humanitarian aid during protracted crisis (Beijnum and Kaput, 2009). Because humanitarian instruments are governed by a different set of principles, donors can allow for more flexible rules and regulations on reporting and accountability for these instruments. One respondent referred to the case of Bosnia in 1993, where the UN High Commissioner for Refugees was working with an 11% diversion rate for its assistance (*i.e.* 11% of humanitarian aid was diverted for non-life-saving purposes). Although exceptional, this was considered acceptable by the donor government concerned, given the circumstances, but it was not acknowledged in the formal accounts of the programme. Another example is the case of WFP, some of whose donors acknowledge that a certain level of diversion of food aid is to be expected in the most high-risk countries. This is an example of accepting high exposure to risk rather than accepting risk outcomes (the diversion of aid). WFP also has a revolving fund (the Immediate Response Account) that provides a facility for rapid and flexible allocations; and its Executive Board has agreed that it can draw on capital reserves (up to agreed limits) to fund programmes based on pledges from donors before these become actual contributions. As such, WFP pre-accepts fiduciary and programmatic risk to a certain degree.

While the use of humanitarian instruments is attractive, they provide only a very limited answer to the challenges posed by fragile and conflict-affected situations. Donors only allow humanitarian agencies to use humanitarian funding to conduct recovery activities to a limited extent, and humanitarian objectives tend to be relatively short term. Also, humanitarian funds cannot be used to support non-ODA activities like security sector reform.

Against this backdrop, transition financing mechanisms are needed that enable flexible and rapid responses to a wide variety of needs and opportunities (perhaps combining ODA and non-ODA). These mechanisms should allow for sufficient levels of control, while taking account of the fact that full accountability is difficult (if not impossible) to achieve in these environments.

Some financial instruments have been specifically designed to manage the (perceived) risks involved in working in fragile situations. These instruments vary in the level of individual donor control they allow over the use of funds:

- Bilateral funding: allows full control, as donors execute their own projects directly (using their own staff or through contractors).
- Pooled funding: allows partial control, as donors pool their funding and are part of the fund management team (and in some cases can decide to earmark their contribution for increased control) or provide earmarked funding to implementing agencies.
- Budget support: allows only minimal control, as fund management is transferred to the partner government (partial control is exercised if sectoral budget support is provided), or unrestricted funds are given to UN or non-governmental agencies.

We discuss each of these in turn below.

Bilateral funding

Many donors have specifically designed financing instruments for fragile and conflict-affected situations. The Netherlands, for instance, has set up the Stability Fund, which combines ODA and non-ODA funds in order to provide rapid and flexible funding for activities to promote peace, security, and development in situations of conflict and fragility. The fund has successfully supported key policy areas such as conflict prevention, mediation, peace keeping and peacebuilding, including SSR and DDR programmes (OECD, 2010). Two factors have contributed to the fund's success: *(1)* the strong political support for and understanding by the Dutch parliament of the need to be flexible and pragmatic; and *(2)* de-linking allocation decisions from questions about ODA eligibility (*i.e.* the decision of whether or not funding qualifies as ODA is made after the funding decisions have been made). The categorisation of activities as ODA or non-ODA only takes place afterwards, enabling the Dutch government to respond to urgent needs in fragile states quickly and without red tape (OECD, 2010).

Similarly, the European Commission has set up the Stability Instrument. This combines short-term elements (under the Directorate General External Relations) with longer-term elements (under the European Co-operation Office). It can also finance non-ODA eligible activities, although according to the OECD transition financing paper it has not yet done so (OECD, 2010). The Stability Instrument is designed for use during crises, allowing the European Commission to skip the tendering and negotiation process. It takes only three months to allocate funds once an opportunity has been identified. This is compared to between one year and 18 months in the normal European Commission development assistance cycle. However, because funding from the Stability Instrument only lasts for 18 months, a key question is who will provide funding after that period. The instrument is designed to be used to support activities that can be linked to longer-term development

instruments. As such, it can be used as seed money. The risk is that the different institutions involved will not ensure that the shift to longer-term engagement actually works in practice. However, respondents state that the Stability Instrument can be used to "try new things", and there is relatively high tolerance if innovation and untested approaches ultimately fail. This instrument therefore allows the European Commission to take risks within certain agreed limits.

Other examples are the US OTI's Transition Initiatives budget (Box 3.3), the Canadian Global Peace and Security Fund and the World Bank's State and Peacebuilding Fund (SPF; see Section 3.1). The latter complements International Development Association (IDA) support by financing small and urgent activities not easily funded under regular IDA credit or grant operations. The SPF has also been used in fragile and conflict situations in countries eligible for International Bank for Reconstruction and Development funding. However, even though the SPF allows for quick funding in situations not normally funded by the World Bank, respondents claim that the bank's strict fiduciary rules prevent the SPF from taking the risks necessary in these kinds of situations.

While fast-track procedures are generally common practice for humanitarian assistance, some donors have also set these up for transitional situations. BMZ, for instance, has a dedicated budget item to development-oriented emergency and transitional aid (known as Title 68720), with related policy strategy and guidelines (BMZ, 2006). This funding is designed specifically to bridge the gap between humanitarian and development assistance by laying the foundations for a longer-term development process – *i.e.* it acts as seed money. Funds from Title 68720 have a special set of rules and regulations (BMZ, 2006):

- they can be allocated on short notice and disbursed quickly;
- the planning and approval process proceeds more quickly than for technical or financial co-operation; and
- there is no requirement to comply with the BMZ's fixed country allocations or to make agreements through government negotiations or exchanges of notes.

Projects funded receive up to EUR 3 million (the overall amount allocated to the fund is about EUR 129 million annually) and the period of assistance is generally between six months and three years. This calls for realistic, not overly ambitious objectives. Development-oriented emergency and transitional aid is provided primarily by GIZ, German non-profit NGOs or international organisations. GIZ's activities are controlled by its general agreement with BMZ. NGOs receive funds based on the guidelines laid down in Chapter 2302, Title 68720, while BMZ signs agreements with international organisations (BMZ, 2006).

Pooling funds, pooling risks

While direct control over the use of funds – as in the case of bilateral funding – makes the assessment of results (and accountability) easier, it also increases political exposure in the event of failure, fund mismanagement, poor results, and so on. In most fragile and transition situations, individual actors have relatively limited control over the outcomes of their interventions. This underlines the value of collective approaches – and collective risk-taking. Pooled funding mechanisms allow individual donors to do this. They involve shared funds supplied by multiple donors guided by a joint strategy and a common set of broad objectives. Typically, pooled funds are set up like a trust fund, where an administrative agent or trustee holds the money until it is allocated. The decision on which activities to support is made by a joint governing mechanism usually made up of representatives of the national government, donor community and implementing partners. In most cases, these pooled funding mechanisms are administered and managed either by the World Bank or the UN. The World Bank, for instance, administers the Afghanistan Reconstruction Trust Fund (ARTF) and the Multi-Donor Trust Funds (MDTFs) in Sudan, and more recently has been selected to act as trustee for the Haiti Reconstruction Fund. The UN administers the Common Humanitarian Funds, the Peacebuilding Fund, and the Sudan Recovery Fund for Southern Sudan.

From a donor perspective, these mechanisms reduce the cost of information, co-ordination, administration and access; in other words, they lower transaction costs, since donors deal with one central fund rather than a plethora of smaller funds and projects. Furthermore, because pooled funding mechanisms follow a joint strategy, which is co-ordinated between the national government and international actors, they are designed to enhance the coherence and impact of aid. Related to this, the joint strategy strengthens donors' bargaining power in relation to partner governments, since it is harder for one donor to be played off against another. This is a real possibility when dealing with newly-established partner governments emerging from conflict. Finally – and from the point view of this study, perhaps most importantly – pooled funds allow the simultaneous transfer and pooling of many of the risks involved in engaging in such uncertain environments:

- Pooled funds offer bilateral donors the opportunity to pool exposure to political and reputational risks by sharing the burden of control and oversight. Where either the security situation and/or political sensitivity do not allow individual donors to be actively involved, pooled funds allow them to engage at arm's length (*e.g.* in Iraq, where the World Bank and the UN jointly administered the International Reconstruction Fund Facility for Iraq). By being one of many, donors feel they mitigate the risk of being singled out if something

goes wrong. However, pooled funds do not completely eliminate these risks – donors will always have to answer individually to their taxpayers and political constituencies.

- Pooled funds are generally perceived to reduce donor exposure to fiduciary risks. However, some donors argue that pooled funds increase fiduciary risks because they have less direct control over fund management and implementation. Combined with the fact that fund administrators and managers do not accept any liability for the use of funds, some donors feel that there is no real burden sharing. Despite this, pooled funds probably do serve to mitigate fiduciary risks because they increase transparency: with all actors following a shared framework there is less room for corruption and the promotion of individual priorities. Thus, pooled funds can mitigate fiduciary risks especially when dealing with possibly corrupt and/or abusive parties to a post-conflict process (Scanteam, 2007).
- Pooled funds are perceived to mitigate programmatic risks – *i.e.* the risk of programme (and ultimately strategic) failure. As pooled funds can only finance priorities defined by the guiding strategy, developed through joint analysis between the national government and international actors, they allow for a more strategic, comprehensive and needs-based response. And the fact that project and programme proposals are assessed by a wide variety of stakeholders does increase the chances of identifying management and operational flaws early on.

However, there are some important caveats to the above. First, pooled funding works best if most donors are involved. However, many donors still bypass pooled funding mechanisms. And while others, like the European Commission, do participate to some extent, they may require compliance with their own fiduciary rules and regulations, which increases transaction costs.

This lack of donor participation in pooled funds is partly due to the requirements of national rules and regulations (*e.g.* for accountability), partly to the unwillingness of certain donors to transfer power to joint mechanisms (as this may weaken their position to pursue their political agendas), and partly to donor dissatisfaction with the results of pooled funding mechanisms to date. On this last point, it is disconcerting to see that donors tend to create new funding mechanisms when existing ones do not deliver as expected, rather than improving the existing instruments (Beijnum and Kaput, 2009). While many donors point to the unwillingness of fund administrators to adjust or improve existing instruments, in their turn fund administrators point to the unwillingness of donors to allow them to adjust the rules and regulations of the funding mechanisms (because a contribution has been made according to a particular set of rules and regulations, the money needs to be accounted for under the same set of rules and regulations; Box 3.5). Undoubtedly, the truth

will be somewhere in the middle. This serves to highlight the need for donors and fund administrators to discuss the flexibility of rules and regulations (and the fungibility of funds) more openly and upfront, *i.e.* before adjustments are needed or mutual recriminations arise. Second, the lower transaction costs associated with pooled mechanisms might be offset initially by the amount of time involved in agreeing and implementing such funds. Initial costs might actually be higher due the time required to negotiate the procedures to follow and priorities to finance, although these costs are frequently offset by the benefits once the mechanism is working, as outlined above.

While donors perceive pooled funds as an opportunity to *pool* risks, fund managers and implementing agencies feel that the donors *transfer* risks: whenever something goes wrong, the managing or implementing agency is held accountable (which in effect means that there is a high reputational risk for these agencies). A key element in all this is the extent to which

Box 3.5. **Pooled funds, fiduciary risk and the limits of effectiveness**

The MDTF Southern Sudan (MDTF-SS) has been highly criticised for its slow disbursement of funds and its lack of results. This example underlines the limitations created by unrealistic donor expectations and fiduciary rules and regulations that are too strict.

The World Bank was appointed by the donor community to act as the MDTF SS trustee, as it was felt that the bank's fiduciary rules and regulations would provide the best guarantee against corruption and misuse of money (a very real threat in post-Comprehensive Peace Agreement Southern Sudan). However, serious delays in allocating funds are partly due to the preconditions and safeguards requested by the donors. These same donors, nevertheless, have been competing to brand the MDTF SS a failure and to blame the World Bank.

The World Bank did indeed make some major mistakes in setting up the fund and its operational facilities; but blame cannot simply be assigned to the bank. It has not been able to allow for more fiduciary risk-taking because its board does not allow the bank's fiduciary rules and regulations to be relaxed. The same donors that criticise the World Bank for this inflexibility sit on the bank's board. The problem is that these board representatives are usually staff from ministries of finance or treasury departments, whose perspective is different from that of the donor representatives that deal with fragile states. To make things more complicated, donor representatives in the field are usually less risk averse than their counterparts in headquarters. With all these different perspectives, there is a great risk of miscommunication, misconception and different expectations.

Source: World Bank (2010): OECD (2010).

donors actually hand over control to managing and implementing agencies. Given the potential political exposure in the event of programme failure and/or fund mismanagement, it could be beneficial for donors to hand over control. However, the potential benefits of this are directly related to the capacity of the managing and implementing agencies to actually take on this responsibility, and the extent to which donors actually allow these agencies to take on this responsibility in transition settings (*i.e.* by allowing sufficiently flexible rules and regulations). Both the willingness of donors to hand over control and the ability of managing and implementing agencies to exercise such control have proven difficult in practice.

Crucially, when delegating control, donors have to make sure that they give the fund management enough room to take risks and respond flexibly to a particular situation, and that they speak with one voice on this. Recent experiences with MDTFs show that certain funds have been ineffective and inefficient, partly due to the rules and regulations imposed by the very donors that criticise the funds on these grounds (Box 3.5). A World Bank MDTF study, for instance, shows that MDTFs do pool risks, but also that the bank is taking substantially more risk than the donors (World Bank, 2010). One consequence of this is that World Bank staff are becoming more and more risk-averse. Respondents to this study pointed out that donor tolerance of failure is higher for bilateral funding than for multilateral funding. At the same time, some UN agencies and the World Bank are less accepting of failure than bilateral donors – largely because of the considerable donor criticism. The current challenge is to weigh the dangers of increasing risk taking against the danger of actual or perceived failure and damage to the reputations of the actors involved, or even the entire aid system. At the moment, two incompatible factors are risking programme failures: *(1)* donors' need for control and full fiduciary satisfaction, as opposed to *(2)* the need to allow the fund to function as intended.

Recent studies and evaluations of MDTFs have identified some critical challenges that need to be overcome in order for these funds to provide appropriate assistance. These include:

- Getting funds up and running quickly.
- Handling the trade-offs between quick delivery and capacity building.
- Avoiding a proliferation of instruments.
- Improving co-ordination and harmonisation by international actors among different funds.
- Defining better how MDTFs should work, such as the degree of national ownership, the speed of operation, overall fund objectives,

and what the funds can and cannot do (in order to manage donor expectations; OECD, 2010).

- Providing more reliable, predictable funding by donors.
- Dedicating sufficient qualified staff right from the start. There is widespread underestimation of the resources needed to manage a pooled fund (both in terms of finance and qualified staff), which increases the risk of management and operational failure.

Some respondents pointed out that a "standard model" is needed for trust funds so that the rules and regulations do not have to be negotiated each time a new fund is established. In fact, some standard documents of this kind already exist (various framework agreements between the World Bank and the UN; the UN Development Group Framework for MDTFs). However, these were drawn up by fund managers. It would be worthwhile for donors to agree on the key elements of a pooled fund, *e.g.* the standard fiduciary rules and regulations, and the key roles and responsibilities of the main actors involved in the fund (such as the oversight committee, the fund administrator/trustee, the managing agent, the implementing agency, etc.). Existing guidelines could be built upon, while asking what is needed for donors to be able to provide political cover to the pooled fund? However, respondents pointed out that the models should not be set in stone – flexibility is needed to respond to the specific context of each pooled fund. The negotiations on the design of the pooled fund should occur in country, involving both the World Bank country director and the UN resident co-ordinator. This again boils down to donor agreement and willingness to hand over control.

Budget support

The thorny question of whether – and under what conditions – it is appropriate to provide direct or indirect budget support is writ large in risky and fragile states. Most donors consider direct budget support inappropriate in these contexts, given concerns about PFM and the fiduciary risks involved (most obviously, corruption). Yet many respondents felt that donors have been spending too much time thinking about how to protect their own funds and not enough on how to align their efforts with existing partner country mechanisms. In recent years, there has been an increase in international pressure to provide budget support (*e.g.* through the Accra Agenda for Action; Box 1.5). For instance, in 2008 Denmark decided to make budget support its default aid method. However, it was not willing to provide general budget support (currently, this makes about 6-7% of total Danish ODA, mostly in a limited number of "normal" developing countries – *i.e.* not in fragile and transition situations). The Danish Ministry of Foreign Affair's Quality Assurance Department has developed 10 criteria for providing budget

support, but many fragile contexts do not meet these criteria. In spite of this, Denmark does provide budget support to Afghanistan, reflecting the perceived political opportunity and the dangers of inaction. This underlines the fact that ultimately providing budget support is a political decision. This is also clear when looking at US policy. Recently, the US government has decided to provide budget support to Pakistan as part of its foreign policy agenda in the region. Linked to this, the US wants to spend more money in Afghanistan through the Afghan government, aiming to channel 40% of its contribution through the government before the end of 2010. In order to do so, six Afghan government institutions have to be vetted to receive US funds.

These examples are exceptions, however, and most bilateral donors are hesitant to provide general budget support to fragile and conflict-affected situations. Institutions like the International Monetary Fund (IMF) could resolve these difficulties. The IMF has set up a Rapid Credit Facility – the first on-budget intervention for fragile situations. The facility can provide concessional terms and so can initiate the process of reconstruction and stabilisation. Countries do not need loans to rebuild, they need grants. The IMF can react quickly, giving money directly to the government and performing a "signalling" function to other donors by focusing on critical reforms needed to provide a platform for further investment. In providing on-budget support, it also contributes to building institutions to help fight corruption.

Bilateral donors also use the European Commission to provide budget support on their behalf. Some respondents felt that bilateral donors "hide" behind the commission in this way. In the West Bank and Gaza, for instance, the EU set up a parallel system for budget support – although the money never went to the government, it did exactly what government money was supposed to do. This allowed donors to contribute, as their money was going at "arm's length" through EU channels.

3.3. Technical assistance

As well as financial support to fragile states, donors are increasingly providing technical assistance. Although the amount of technical assistance had started to decline in recent years following perceptions that it clashed with the principles of ownership and sustainability, the tide seems to have turned once again, especially for fragile and transitional settings. Where partner governments are willing, but as yet unable, to take full control over donor money, donors are funding capacity building. Supporting capacity development is a form of risk management, given that weak local capacity is a key risk factor for aid interventions. This is particularly true of capacity building for both local internal control mechanisms (administrative capacity, fiduciary risk management) and external control mechanisms (political capacity, state legitimacy).

As donors have full control over the technical assistance they provide – generally carried out by their own, or directly-contracted, staff – it is often a preferred assistance approach for controlling and reducing fiduciary risk in particular. It is also perceived to increase the flexibility and speed of interventions in fragile states. To support this, many donors have set up so-called "expert rosters" (Box 3.6): pools of experts who can be sent abroad on rapid assignments at short notice. These rosters cut donors' reaction time to foreign crises. The rosters also allow the pooling of different kinds of expertise and experience; their express purpose is to enable individuals to be recruited for their expertise rather than their departmental affiliation.

Box 3.6. **Donor experiences with expert rosters**

Several of the donors reviewed for this report have set up expert rosters. Sweden, for instance, has organised a pool for sending police officers to international policing missions, and the Netherlands has established the integrated SSR Pool, which brings together military (former defence) personnel and civilian (juridical) experts to support the implementation of SSR activities (OECD, 2006). The Netherlands MFA has a "political advisor pool" consisting of experts who can be sent quickly to Dutch embassies in the event of an urgent need to boost their capacity (Clingendael Institute, 2006), while the Australian government relied on staff pools to support its missions in the Solomon Islands (Cook, 2006). More holistic pools are also being organised, and many multilateral organisations – including several UN bodies, the African Development Bank Group and the World Bank – have also organised, or are planning to organise, expert rosters. For example, the World Bank has set up a pool of fiduciary experts to be sent to fragile states.

Notes

1. GIZ was formerly GTZ (German Technical Cooperation).
2. OTI is now active in nine countries: Afghanistan, Colombia, Haiti, Kenya, Lebanon, Pakistan, Sri Lanka, Uganda and Venezuela.

Chapter 4

Ways forward: taking appropriate risks

Chapter 4 looks at some practical options to help donors take appropriate risks in fragile and transitional contexts. It begins by looking at some of the approaches adopted in the private sector (particularly the financial and commercial sectors) and the parts of the public sector not dealing with aid, and considers their relevance for the aid sector and fragile and transitional settings. It then looks at some of the lessons from two areas of practice where risk management is central: working with politically corrupt systems and undertaking local procurement. Case studies of donors' approaches to corruption and local procurement provide a wealth of ideas for how these important issues can be dealt with in fragile and post-conflict situations.

As we have seen, there are some obvious fault lines and tensions in exploring the subject of risk and aid. Most fundamental is the apparent tension between a desire to be "risk taking", flexible and innovative in transitional contexts; and, on the other hand, the need to comply with international aid principles, demonstrate results, prove the taxpayer is getting value for money, be financially accountable, avoid corrupt practice, meet minimum best practice standards and avoid other risks to institutional or political reputation. "Playing it safe" seems like a recipe for failure in these difficult environments, but it is not hard to see why institutions and their staff might do so, given the number of factors for which they are held accountable. So what is the responsible alternative and how can it be justified? What is the right balance between opportunity and risk? If a different balance is required, what would need to change in institutional and individual practice, and how can such change be achieved? Perhaps most challenging of all, how can we achieve change in *collective* behaviour, both within the international donor community and more broadly within the aid community?

In this chapter we consider what it means to take *appropriate* risks in fragile and transitional contexts. There is clearly no single answer to this. It hardly needs to be said that the context (external and internal) must determine what is appropriate in each case, and that each organisation will judge this for itself. That said, examples of approaches and mechanisms are available that appear to work better than others; and in some areas there is clearly a need for new approaches to risk and risk management.

We begin by looking at some of the approaches adopted in the private sector (particularly the financial and commercial sectors) and the parts of the public sector not dealing with aid, and consider their relevance for the aid sector and fragile and transitional settings. We go on to look at some of the lessons from two particular areas of practice where risk management is central: working with politically corrupt systems and undertaking local procurement. In both cases, balancing risk and opportunity is a recurrent theme.

4.1. Risk management: lessons from other sectors

Risk analysis and risk management are much more advanced disciplines in the commercial sector – and particularly the financial sector – than in the public sector. Even in the public sector, development assistance lags behind some other public services in its thinking about risk. Development assistance practitioners have more to learn from other sectors about the culture and psychology of risk as it relates to individual and group behaviour. Other useful lessons concern the analysis and management of risk. The literature on both is extensive. Yet the complexity and peculiar nature of the aid enterprise, particularly in fragile settings, means that it is difficult to transfer

techniques or approaches from one sphere to the other. For example, many of the risk models in the financial sector depend on being able to predict market trends, weigh risk and opportunity based on anticipated market behaviour, and make appropriate "hedges" against adverse movements. The ability to "price" risk accurately is the stock in trade of the insurance industry; and it is the aspect of global investment banking that recently went so badly wrong when the risk involved in individual transactions could not be determined and the instruments being traded became so complex that managers could not understand their implications, or else were able to turn a blind eye to these implications.

In one sense, this study too is concerned with pricing risk and with potential return on investment. Just as high-risk stocks carry high potential returns in equity markets, so in the aid enterprise – and particularly in fragile states – we may be willing to bear a high risk of failure if the stakes are high enough and the potential rewards great enough. To quote the new UK Secretary of State for International Development: "… sometimes we need to experiment with innovative approaches which run the risk of failure – but which could deliver great returns if they work. We fully accept this 'venture capitalist' approach to aid. Our work to strengthen impact evaluation will give us firmer evidence about the poverty-reduction 'return on investment' of different approaches, allowing us to scale up and replicate successful new ideas." (The Conservative Party, 2010)

First we look at the lessons that may be learned from the way in which the private sector thinks about and manages risk, then turn to areas of other public sector practice that may be instructive. Annex A discusses the bases of risk analysis.

Learning from the commercial sector[1]

Insurance

The natural starting point is the insurance industry, which deals explicitly with risk both on its own account and that of its clients. Insurance is designed specifically to indemnify against loss. It is based on the principle of pooling together a series of monetary contributions over time from many individuals. Each individual therefore avoids disaster by contributing relatively small amounts to a pool at regular intervals, but has the right to remove large amounts in the case of a major loss. The actual amount contributed (the premium) is determined by the probability and size of potential losses. By transferring and managing risks, insurance increases economic efficiency and allows many transactions to be completed or actions taken that would not have been otherwise.

Commercial organisations protect themselves against loss in many ways, some of which (like letters of credit, used to reduce the risks of international trade) are woven into the very fabric of commercial transactions. There is no space to review the various methods here, but it is worth noting that they all come at a cost – and that this is subject to cost-benefit calculations. With regard to fragile states, it is also worth pointing out that companies doing business there are likely to take out political risk insurance – essentially, a mechanism to mitigate the impact on commerce of adverse actions, or inactions, by governments and political groups in such settings. Different companies are likely to be faced with different variables. A mining company, for example, may face a different set of risks than a bank operating in the same political or security context. An insurance provider must fit the model to the company or project (Howell, 1998). The wider point here is that sophisticated political risk analysis is central to the activities of commercial companies working in high-risk environments.

The principle of insurance, in theory, can be applied to risk management in the aid sector. Indeed, the use of insurance instruments is an increasing feature of disaster risk management, with aid monies being used to pay premiums on insurance policies or to buy equivalent cover through devices such as financial derivatives (*e.g.* "put" options), which are used to hedge against the effects of severe weather or adverse movements in commodity (*e.g.* food) prices.[2] For recurrent hazards, this is rational way of managing risks – or at least, the risk of major financial loss. Mutual schemes, such as the Caribbean Catastrophe Risk Insurance Facility, are examples of this. An index-based scheme, this facility provides immediate liquidity if hazards arise; and the mutual nature of the scheme reduces premium costs by 40%. Another example is the use of catastrophe bonds to transfer risk to the global financial markets. Investors receive an above-market return when a specific catastrophe does *not* occur, but they lose interest or part of the principle if it does. Mexico has issued an innovative "cat" bond to cover the risk of a disastrous earthquake, providing a potential model for other countries. At the other end of the scale, micro-insurance schemes have played an increasing role in development approaches in recent years.

Besides the use of market-based risk transfer mechanisms, the insurance model is a useful one for thinking about pooling and transferring donor risk in high-risk environments. So too is the notion of portfolio risk management, based on the principle of managing risk by diversifying investments. The practice of portfolio management in the financial sector is a highly technical and specialised quantitative process, based on rules of market behaviour. Precision of this kind is not possible in the aid world, where "investments" are in any case of a different kind. But the principle of diversifying investments is a useful one, including the idea of balancing high and low-risk programmes and "hedging" by allowing for different possible scenarios in the range of programmes selected.

Some donors (*e.g.* DFID) are increasingly thinking along these lines. They are also increasingly using the language of *venture capital*, which combines the ideas of innovation, high risk and potentially high-return investments. Most venture capital investment in the commercial sector is made on a pooled basis so that risk is spread across a range of high-risk investments, and losses in one part of the portfolio (perhaps the major part) are balanced by high gains in another.

Enterprise risk management

The concept of enterprise risk management (ERM) is of more general relevance to aid institutions seeking to manage risk across the range of their activities (see Section 3.1). This is a framework to ensure holistic, organisation-wide risk management. Originating in the commercial sector, it is increasingly being used in public sector management (Box 4.1. and Table 4.1).

It is up to senior managers and the company's board to establish "bottom lines" and the basic parameters for risk-taking within an organisation. While these processes are designed to help manage institutional risk, they depend for their success on awareness of both external and internal risk factors. This is

Box 4.1. **Enterprise risk management**

Key aspects of ERM involve establishing clear lines of management and governance responsibility; processes for identifying and monitoring key risks for the organisation concerned; and data and analysis tools for monitoring and evaluating risk. This typically includes reforming:

- Corporate governance, to ensure that the board of directors and management have established the appropriate procedures to measure and manage risk across the company.
- Line management, to integrate risk management into the activities of the company.
- Portfolio risk management, to aggregate risk exposures, diversify the portfolio and monitor risk concentrations against established risk limits.
- Risk transfer, to transfer out to a third party risk exposures considered to be too high or not cost-effective.
- Risk analytics, to provide measurement, analysis and reporting tools.
- Data and technology resources, to support the analytical process.
- Stakeholder management, to communicate the company's risk information to its key stakeholders.

particularly relevant to aid to fragile states, where the costs of non-engagement have to be weighed against competing factors (risks and opportunities), which may include staff security, fiduciary responsibility and institutional reputation.

Learning from risk governance in the public sector

This is another huge subject area; here we can only consider one or two relevant aspects. The obligation of governments to protect the population at large from hazards forms the basis of risk governance in the public sector. These hazards may be natural or human-made (Box 4.2). The balance to be struck is often not just between costs and benefits, but between individual or commercial liberty and the safety of the public. The extent to which safety considerations influence public policy is conditioned by a number of factors, including the public's own risk perceptions and the way in which public sector liability is interpreted by a country's legal regime.

Box 4.2. **Human-made risks and risk governance**

At midnight on 3 December 1984, the Union Carbide pesticide plant in the Indian city of Bhopal accidentally released methyl isocyanate gas, exposing more than 500 000 people to the deadly gas and other chemicals. Twenty-five years later, toxic chemicals from the plant continue to pollute the ground water in the region, affecting thousands of Bhopal residents who depend on it.

Two years after this event, on 26 April 1986, reactor number four at the Chernobyl nuclear power plant in the Ukraine (then part of the Soviet Union) exploded. The resulting fire sent a plume of highly radioactive fallout into the atmosphere and over large parts of the western Soviet Union and Europe. Large areas in Ukraine, Belarus and Russia were badly contaminated, resulting in the evacuation and resettlement of over 336 000 people.

One of these organisations was a commercial enterprise within a state regulatory framework, the other a state-run enterprise. What links these disasters are human error, poor systems and negligence – factors that are controllable in principle, but which to some degree seem to be inherent in any human enterprise, particularly where political and commercial factors are at play.

Other disasters that appear to have principally natural causes (*e.g.* floods) often turn out on closer inspection to be the avoidable result of failures of planning, investment and risk management. Sometimes the events in question – particularly those related to violent conflict and criminal activity – are the result of deliberate human action, stemming from behaviours over which there may be little public control. Calculating and managing risks of this kind are much more complex activities.

The key principle is the precautionary principle (related to the "do no harm" principle, Box 1.5), which has recently gained prominence in debates about climate change. According to one definition,[3] this principle states that if an action or policy may cause harm to the public or the environment, in the absence of scientific consensus that the action or policy is harmful, the burden of proof that it is *not* harmful falls on those taking the action. According to the same principle, decision makers are required to anticipate harm before it occurs and take appropriate steps to minimise it; a lack of scientific consensus is not to be used as an excuse for failure to do so.

The meaning and application of the principle – and of its softer formulation as the "precautionary approach" – are widely debated. But it remains an important part of public policy thinking about public health and the environment, sometimes to the extent of being a legal requirement (*e.g.* in EU environmental policy). A UK parliamentary committee had this to say about the principle: "Policy guidelines such as … the 'Precautionary Principle' are imprecise and there is a danger that they can lead to an excessively cautious approach to risk. Unless these concepts can be clarified, they should be discarded … More attention should be paid in the formulation of policy to the trade-off between personal liberty and public regulation" (UK Select Committee on Economic Affairs, 2006).

4.2. Understanding corruption and the risks it presents

Corruption is frequently identified as one of the key risks for donors providing funding to fragile states, both as a harmful outcome in its own right and as a risk factor for other outcomes (Box 4.3). But different contexts and different forms of corruption present different risk profiles – and the extent to which corruption is avoided, managed or accepted depends in part on the nature of the trade-offs involved with other risks. In assessing each case, donors need to decide whether the corruption risk is serious enough to affect their decision to fund, what to fund, and how best to fund it; and then to decide on strategies and specific measures for managing the corruption risks and risk factors. Here, as always, a cost-benefit calculation has to be made; and in fragile states and transitional contexts this can present particular dilemmas.

Donors in general are not highly risk averse when it comes to corruption: in many cases they continue funding fragile states despite the known prevalence of corruption.[4] Yet most have strong anti-corruption policies, including "zero tolerance" policies in some cases. In other words, donors appear to accept a high degree of exposure to corruption risk in certain circumstances, but try to manage that risk in a variety of ways.

A number of factors make it difficult – but not impossible – to tackle systemic corruption in fragile states. These include the state's limited capacity, particularly its judicial and law enforcement agencies; the lack of financial resources for accountability; and insecurity of and threats to oversight bodies. However, a fragile situation may present rare opportunities to establish governance systems that are free of corruption. It is very difficult to remove corruption once it has become entrenched within a political system, but the period when new institutions and political systems are being created offers a small window of opportunity to build in anti-corruption measures and broader accountability systems from the start.

Box 4.3. **What is corruption? A typology**

The term "corruption" is most often used to refer to political corruption; *i.e.* the abuse of official power for private gain. This can take various forms: bribery, extortion, cronyism, nepotism, patronage, embezzlement and so on. It may be associated with certain kinds of criminal enterprise such as trafficking or money laundering, and it is often closely associated with the attempt to maintain political power through patronage.

In a wider sense, corruption can refer to any situation where entrusted power is abused for private gain, *e.g.* in a commercial organisation. More importantly for the purpose of this study, it applies to the abuse of power by organisations in the aid chain, or individuals within them. It may occur within "beneficiary" organisations that are intermediaries between aid providers and recipient communities. This type of corruption is not the same as the theft or diversion of aid resources by people not involved in the aid delivery chain.

Within this definition there are two forms of corruption:

- **Direct corruption:** aid money that is directly lost to corruption. Examples are institutional corruption, *i.e.* the direct loss of aid to corruption.
- **Indirect corruption:** where aid money supports a corrupt system or generates corruption within a country. Examples are contextual corruption.

Programmatic corruption risks may fall under either heading. Measures to manage and mitigate corruption risks also fall into the direct and indirect categories, according to the type of risk in question (Box 1.1). Contextual corruption risk tends to be mitigated by supporting political, governance and specific anti-corruption reforms. Internal controls or technical conditions are used to reduce institutional corruption risks.

Using this typology of contextual, programmatic and institutional risks, a more detailed classification of corruption risks is set out in Annex C.

Donors need to consider the *evidence* that is available about the presence of corruption and the likelihood of their aid fuelling it. There are many generalisations – even myths – about corruption that should be challenged as part of an evidence-based approach. A key difficulty for donors is that they are likely to have limited or imperfect information on which to base their decisions. Even where there is evidence of corrupt practice, donors may be unwilling to share it because it might threaten their reputations, reduce public support for development assistance and ultimately lead to reduced government funding for international development. Sometimes donor governments' own accounting systems fail, exposing them to major corruption risks (Box 4.4).

Box 4.4. **Accounting for funds in Iraq**

In July 2010, Reuters reported that the US Department of Defense (DoD) was unable to account properly for USD 8.7 billion of Iraqi oil and gas money assigned to humanitarian needs and reconstruction after the 2003 invasion, according to an audit report from the US special inspector-general for Iraq reconstruction (SIGIR). "Weaknesses in DoD's financial and management controls left it unable to properly account for [USD] 8.7 billion of the [USD] 9.1 billion in DFI funds it received for reconstruction activities in Iraq", the SIGIR report said. The report described lax management of some of the billions of dollars designated for rebuilding war-shattered Iraq, in a country where residents routinely complain about lack of electricity and other basic services more than seven years after the invasion. "The breakdown in controls left the funds vulnerable to inappropriate uses and undetected loss", the SIGIR report said.

Source: Reuters Baghdad, 27 July 2010.

The information gap

For many donors, the main challenge to developing a stance on corruption is the lack of information about the extent and nature of corruption, particularly in fragile states. Often it is *believed* that corruption is widespread in a particular state, but evidence is either scarce or not available on types and levels of corruption, losses due to corruption, and other negative effects. The available evidence may come from local or international sources, including the indices produced by the World Bank, Freedom House and Transparency International; economic modelling, which also gives evidence of corruption levels; and evidence from investigations into corruption by local authorities and investigative journalists. Sources may also include donor agencies sharing confidential information, for instance on their own corruption losses – although such information is currently hard to come by. Co-ordinated approaches may be necessary in order to reduce this information gap.

How do donors reduce the risk of corruption in fragile states?

When working in environments with high levels of corruption, it is easy for donor agency staff to become demoralised and fatalistic about corruption. Nonetheless, addressing corruption risks is possible and worthwhile.

Donors' anti-corruption policies (*e.g.* Australia, Denmark, Finland, France, Germany, Japan, Sweden and Switzerland) generally apply to recipient countries as a whole, with no distinction made between fragile states and other developing countries. Some, such as Denmark, have adopted "zero tolerance" policies (see Section 2.5).

Most OECD DAC members emphasise the importance of addressing corruption risks in fragile states without necessarily developing comprehensive strategies to do so. In terms of the impact of existing strategies, USAID's Anti-Corruption Strategy states correctly that "… little is known about the possible effects of various anticorruption interventions in such environments" (USAID, 2005b). What evidence there is – referred to below – tends to be piecemeal, anecdotal or case specific.

The sections below describe how donors tackle each type of corruption following the typology in Box 4.3.

Direct or institutional corruption

To prevent institutional corruption, donors tend to put in place a set of internal controls to minimise the direct loss of aid money to corruption (see Box 4.5. for Uganda example). For example, they might require that development projects and loans include a fiduciary risk assessment with a complete financial accountability and procurement assessment.

As we have seen, most donors do not differentiate between fragile states and other aid recipient states regarding institutional corruption risks. For example, while the Austrian Development Co-operation notes that projects and programmes in post-conflict or post-disaster states are generally more prone to corruption, it does not have a separate strategy for mitigating corruption risks in these cases. That said, its policy on good governance includes anti-corruption measures, such as anti-corruption clauses in agreements and quality criteria in project cycle management and monitoring.[5]

The Government of Ireland published its *White Paper on Irish Aid* in September 2006 (Government of Ireland, 2006), which sets out its approach to dealing with corruption. This approach includes extensive oversight of government spending on aid by the comptroller and auditor-general, the Oireachtas Public Accounts Committee, the Oireachtas Foreign Affairs Committee, the Advisory Board to Irish Aid, the Department of Foreign Affairs Audit Committee and the department's Evaluation and Audit Unit.

Box 4.5. **Follow the money: the case of Uganda's education system**

In Uganda, a Public Expenditure Tracking Survey (PETS) or "follow the money" initiative that was implemented in 1996 was directed at the education system. Uganda was suffering at that time from "leakages" of funds of between 20% and 80%. The success of this initiative led to similar projects being implemented in 13 countries. The strength of the PETS methodology lies in its simplicity. It is basically a survey that measures the amount of funds received by each link of the public service delivery chain from a nation's treasury down to the service delivery unit where it is supposed to be spent. In Uganda, it was revealed that in 1995 only 26% of the cash intended for primary schools reached the schools. Many were not even aware that they were entitled to such funding. After the findings of the survey became known, the Ugandan government conducted a public information campaign and the Ministries of Local Government and Finance started to publish monthly data in national and local-language newspapers. The success of this initiative was based on the combination of a quantitative surveys and a qualitative public information campaign.

Sources: DFID (undated); Sundet (2008).

Continued investment in personnel and management systems is thought to be essential to the planning, implementation and oversight of the Irish Aid programme (Government of Ireland, 2006).

In Norway, the Norwegian Agency for Development Co-operation (NORAD) supports statebuilding in fragile states and the public sector through budget support, independent media and anti-corruption efforts. To address institutional corruption risks, NORAD is committed to strengthening recipient countries' financial management and auditing capacities (Norwegian MFA, 2008).

In the UK, DFID has a zero tolerance approach to corruption with regard to its funds, and some of the direct measures it has put in place include a mandatory fiduciary risk assessment of the partner country's financial management and procurement systems, as well as a country governance assessment. Additional safeguards consist of audits and reviews to monitor aid programmes and measures to strengthen UK systems, and counter bribery and money laundering.[6]

USAID pays particular attention to countries in crisis: the agency's Fragile States Strategy notes "high levels of state-sponsored corruption" as one of the factors leading to state failure (USAID, 2005a). Generally, USAID focuses on prevention mechanisms covering the administrative, audit, oversight and civil society participation, including project-based assistance and oversight of contractors and grantees, and extending general budget

support only to select countries that agree to manage funds for their intended purposes (funds are subject to USAID audit; USAID, 2005b).

Corruption features within the whole-of-government approaches of several DAC member countries, including Australia, Canada and the United States. An integrated approach that allows states to combine activities in the areas of security; political and economic affairs; aid; and humanitarian assistance is also likely to assist in tackling corruption, because of the complexity of the problem (OECD, 2009).

Programme and contextual corruption

Programme and contextual corruption risks tend to be managed through donors' support for governance reform, institutional development and anti-corruption efforts within the country (or within recipient agencies) rather than being directly linked to aid programming. For example, a donor agency might attempt to reduce institutional corruption risks when it funds a fragile state's health ministry by requesting an audit or reporting of expenditure. It may separately address contextual corruption risks by funding the work of an anti-corruption agency with the remit to review corruption cases in all government ministries or by supporting the development and enforcement of an access to information law.

This approach is outlined in the European Commission's *Communication on Governance and Development* (2003), which looks at corruption threats faced in countries receiving aid. This document states that "… combating corruption ought to be done within the framework of broader support to strengthen good governance and democratisation processes", which means involving civil society, the mass media, the office of the public prosecutor and the judiciary, and the financial administration, while establishing transparency in public procurement and public service appointments, and effective parliamentary accountability.

In its White Paper on Aid, Ireland emphasises the importance of partner countries' own governments and people in combating corruption (Government of Ireland, 2006). As part of broader efforts to tackle corrupt practices, it promotes mechanisms like support for free and fair democratic elections (*e.g.* through the provision of election monitors and support for electoral commissions); reforms of parliaments and parliamentary processes; and empowering independent regulatory offices, such as ombudsman's offices. Moreover, in Africa, Ireland supports the building of pan-African political institutions, which also aim at reducing corruption and improving the accountability and effectiveness of governments and countries receiving aid. Working with recipient governments is not the only way donors approach the problem of corruption: the Irish government also recognises the role of civil society in holding governments to

account, including citizens, advocacy groups, civil society organisations, human rights groups, private sector organisations and the media (Government of Ireland, 2006).

Norway is also working to reduce contextual corruption risks by supporting watchdogs and the development of well-functioning judicial systems, parliaments and political parties, independent media, and an active civil society.[7]

There are concerns that the measures described above are often not enforced, although there is little recent research on the subject. For example, the Asian Development Bank has very rigorous anti-corruption standards. But the U4 Anti-Corruption Helpdesk cites an assessment which showed that the bank "… almost never complied with the policy requirement to explicitly address corruption issues in its reports, assessments, and evaluations." (U4 Anti-Corruption Helpdesk, 2004). This is an example of the more general problem of inferring practice from policy statements.

Corruption in project funding and implementation

For aid delivered as project funding, there are a number of stages at which corruption can occur. In practice, most donors explicitly or implicitly use a form of cost-benefit analysis to decide if the possible losses to corruption and other potential negative effects are sizeable enough to justify the cost of anti-corruption measures or whether the project should instead be cancelled.

Project definition and selection stage

"Upstream" corruption may lead to project definitions (terms of reference, calls for proposals, etc.) which are based on partial, private or marginal interests rather than the public interest, and which benefit narrow groups of the population or have no discernable benefit. Addressing corruption at this level involves putting in place the kind of oversight mechanisms described above. Many of these measures are equally applicable in donor countries and in recipient countries – it depends on who is responsible for deciding which types of project are necessary. In many fragile situations, the recipient government does not have the capacity to establish oversight bodies or to carry out thorough needs and feasibility assessments.

Whether the donor agency or the recipient government itself selects the projects to be funded, there are a number of ways in which corruption can influence the decision. Most obviously, a decision might be taken to grant project funding to a favoured organisation without an open selection process. In some fragile states there are extremely complex systems of relations between government agencies and contractors, including systems of benefits

and favours and patterns of influence. Disentangling these and proving corruption is often very difficult. For example, it may simply be that it is "understood" that as the result of a favourable decision, at a certain point in time a fee of some description – financial or other – will be expected. There is a grey area because the boundaries between corruption and competitive business practice are not always clear. In addition, in many countries there are likely to be allegations and suspicions that corruption has led to decisions about project selection, when in fact that is not the case.

Sub-contracting can raise many opportunities for corruption. In many cases, there are long aid "chains" with funds disbursed from level to level through sub-contracting or re-granting. The forms of corruption described above may occur at every point. As the amount of funds get smaller, a proportionality test might indicate that putting rigorous and expensive anti-corruption standards in place is not worthwhile. There are always other factors to consider, however. While any media attention may be focused on decisions higher up the aid chain, communities and the broader population might be more aware of what is happening at the end of the chain, *e.g.* which company has the contract to reconstruct a building or a bridge.

Tools have been developed for addressing corruption in project selection. For example, Transparency International's programme on public contracting sets out many ways to minimise the risks of corruption in procurement processes, some of which have been applied in fragile situations.[8] Proportionality and indeed logic should come into play: the types of measure put in place should be commensurate with the size and importance of contracts; the administrative requirements of the projects; and the corruption risks present.

Project implementation stage

Project implementation can bring another set of corruption risks into play, including theft of funds, false accounting, misappropriation of goods, acceptance of bribes or eliciting of favours, and nepotism or other bias in hiring decisions. Donors use many different measures to minimise corruption risks in project implementation. The main focus tends to be on financial reporting, including requiring audited accounts of project expenditure, and project evaluation to determine that the funds were used as intended. Increasingly, donors request that project applications or bids include conflict risk assessments and anti-corruption strategies, although research also indicates that these measures are often not applied in project implementation.

Again, it may be necessary to be more tolerant of corruption risks (as opposed to tolerance of verifiable corruption) in fragile situations because of the urgency of needs and because of the lack of capacity to apply anti-corruption standards. However, this needs to be weighed against the negative

effects of corruption. The "do-no-harm" principle applies here (Box 1.5), and projects that are beset with corruption can generate many negative effects, including the empowerment of corrupt elites or armed groups.

Some believe that corruption is an inevitable feature of early reconstruction but that it will be reduced as development occurs. In fact, the opposite seems to be true: tolerance of corruption in early recovery leads to its institutionalisation and the undermining of political processes in fragile situations. It is very hard to remove corruption from a system once it has been established and become common practice. Far from "buying peace", corruption frequently consolidates the power of those who are not committed to peace, including those who have profited from the war economy and are in a position to exploit aid in the aftermath of a conflict.

In order to deal with the lack of capacity to tackle corruption in aid projects, donors often accept that a certain proportion of project funds will be lost to corruption. In many cases, they choose to work with trusted organisations to reduce their exposure. Relying on international contractors can cause problems, however. For example, it creates a parallel system, separate from and possibly in competition with, the partner government. This may prevent the government from developing their own capacity to manage aid funds and deal effectively with corruption risks.

One of the key internal risks in project support is corruption in procurement. There are many dimensions to corruption in this area, including collusion among bidders, overstating costs in bids, bribery to influence officials' decisions, trading in influence by officials, conflicts of interest leading to the awarding of contracts to allies or relations of the officials making procurement decisions, and so on. Attempts to establish fair and transparent public contracting systems in fragile states have been undermined by bad donor practice, but there are positive examples of donors building rules on procurement into their development policies and procedures, and also attempts to develop common standards. Among the potential risk outcomes associated with procurement are harm to intended recipients and long-term reputational damage to donors and agencies. Managing the risks of local procurement is discussed further in Section 4.3 below.

How do donors deal with corruption in practice?

Having looked at current donor policy approaches to reducing corruption risks, we now look at some of the ways in which donors have attempted to manage and respond to these risks in practice, both before and after they materialise. We review evidence of the impact of such attempts, both positive and negative. Again, the main focus here is on political (government) corruption, both as a direct and indirect risk affecting aid intervention.[9]

Punitive measures, conditionality and the withdrawal of aid funding

Faced with evidence of widespread corruption, donors have sometimes decided to suspend or reduce aid. Zimbabwe, Chad and Eritrea are among the examples of fragile states where this approach was adopted – although it should be noted that corruption alone was not the reason for suspending aid in any of these cases. In order to make anti-corruption commitments credible – especially as part of a "zero tolerance" approach – donors must be prepared to take punitive measures if corruption is discovered. But in their attempts to reduce corruption risks, donors have often chosen to use their influence in other ways, while "tolerating" existing corruption, because of the likely political and humanitarian consequences of withdrawing aid funding.

The decision to suspend or reduce aid will be based on an assessment of its likely impact. Evaluations of decisions to exit from a country are informative here. A 2008 study jointly undertaken by Denmark, the Netherlands, Norway and Sweden looks at five cases of various decisions to suspend aid, two of which might be considered fragile states: Eritrea and Malawi (Disch *et al*., 2008). Although not definitive due to the lack of available evidence on the broader effect of aid suspension on society, the study concluded that the decisions to suspend aid in these cases were problematic, with negative consequences both for the populations concerned and for relations with these countries' governments.

Studies of the use of aid suspension as a sanction by the European Commission show mixed results, with a positive impact in cases where the desired outcome was a return to democracy, such as Côte d'Ivoire; and limited impact on governance when entrenched corrupt and undemocratic regimes were in place, as in Zimbabwe. Again, political relations between the donor and the partner government were – predictably – damaged in the cases reviewed.

The U4 Anti-Corruption Helpdesk analysed these studies and other available material. It concluded that there is no "consistent evidence that the levels of corruption were reduced or that governance improved as a result of donors pulling out of countries" (U4 Anti-Corruption Helpdesk, 2004). Its analysis relates primarily to contextual risks of corruption and to some extent to programme risks. While withdrawing or reducing funding is unlikely to have an impact on the overall governance situation in the country, it will reduce exposure to programme and institutional corruption risks. Withdrawal, in other words, may be justified simply in terms of reducing aid risks, even if it has no wider impact on governance and contextual corruption risk.

When considering this issue, donors should also consider:

- Whether the suspension or reduction of funding could actually *increase* the contextual corruption risks. While the donor's funds will be protected, the partner government may now seek funds from other donors and/or investors who are less rigorous in their approach to corruption.

- The loss of influence that follows withdrawal or scaling down. This has to be set against the opportunity costs of providing aid that is being lost to corruption and the negative effects of legitimising a corrupt government.

Anti-corruption conditionality

Suspending or reducing aid is viewed as an extreme measure and is applied relatively rarely. Imposing conditions on aid "up front" is more common. Attaching anti-corruption conditions to aid requires the recipient state to put in place institutional safeguards, usually relating to PFM, before aid is disbursed. If reforms are not put in place, then aid is not released. Most donors agree that some minimum conditions need to be satisfied before aid can be released, including the presence of functioning institutions, audit bodies, etc. These conditions minimise direct corruption risks, making it less likely that aid is then lost to corruption. That said, some of these conditions may be hard to satisfy in fragile and transitional states, and inevitably put limits on the speed and flexibility with which aid can be channelled by this route.

The evaluations reviewed by U4 show that conditionality can have mixed results (U4 Anti-Corruption Helpdesk, 2004). Their main conclusions are that conditions can reduce the risk of institutional corruption and lead to short-term gains, such as prosecutions, investigations and the establishment of anti-corruption bodies. However, they have little impact on wider political reform and probably do not reduce contextual corruption risks (although there have been some successes in this regard). While these results have been dismissed by some, the importance of reducing corruption in aid flows should not be understated, given the possible spill-over benefits and the money saved.

What are the links between budget support and corruption?

A number of major donors – DFID (2009), the European Commission (2009) and the Nordic aid agencies (MFA/Danida, 2003; Norwegian MFA, 2008; and Norad website[10]) – have all considerably increased their proportion of funding given as budget support in the last ten years. When it comes to corruption risks, DFID and the Danish International Development Agency (DANIDA) have stated that budget support is less prone to corruption, at least in the longer term. DFID carefully considers the country context and government systems before providing budget support. DANIDA believes that,

> *…in the short term corruption in the implementation of development aid can be reduced by increasing controls, tightening procedures, extending the donors' influence and reducing the partner organisations' responsibility, etc. – in short, returning to a more hands-on approach. But in the longer term this will not increase*

partners' capacity and change their approaches to governance, and will therefore not lead to an overall reduction of corruption. (MFA/ Danida, 2003)

The DAC donor preference for budget support has more recently been extended to funding in some fragile states. Providing budget support to fragile countries affected by corruption poses a range of challenges. A joint evaluation of general budget support mechanisms in seven countries (Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda and Vietnam) between 1994 and 2004 concluded that as a method of providing aid, general budget support can be adapted to a variety of economic, political and institutional settings.[11] It also concluded that general budget support requires a basic level of trust and information sharing between the partners – something that is frequently undermined by corruption.

Certain conditions need to be in place for budget support to be most effective. The evaluation cited above sees this as including "… a genuine political determination to combat corruption in the recipient country, a broad anticorruption strategy that covers most of the public administration, an active civil society, and a free press that can keep a strict watch on the public sector, as well as flexibility in the ways in which interventions to combat corruption should be started." The case studies were inconclusive on the question of corruption, with some showing that budget support is more vulnerable to corruption, others that it is less so.

Most donors echo these conclusions in their own policies. The Finnish MFA, for example, says "… direct budget support should be provided only if the state's financial administration is predictable and transparent." The evaluation cited above also concludes that "[t]here was no clear evidence that budget support funds were, in practice, more affected by corruption than other forms of aid." A 2008 U4 issue paper on corruption and different aid modalities concludes that there is a lack of evidence on the relationship between corruption and budget support and recommends a tailored rather than a blanket approach, including supplying different types of aid.[12]

The conditions identified above are often *not* in place in fragile states. U4 states that "… budget support is highly problematic in countries that experience endemic corruption and a repressive government. In such contexts, there is a very high risk that allocation decisions are driven by rent-seeking motives and that budget support may be misused by incumbent governments to highjack domestic accountability." It recommends a combination of aid modalities (U4 Anti-Corruption Helpdesk, 2004).

At the very least, budget support models should be adapted for use in fragile states. As the Irish government emphasises in its White Paper on Irish Aid, engagement in vulnerable environments requires "new ways of working"

that involve investment in the structures and mechanisms of government, policing, capacity building, and the justice system. Moreover, the white paper highlights that in such circumstances, it is not always possible to deliver programmes directly to governments (Government of Ireland, 2006). An alternative way is to rely more on NGOs and international organisations (see below).

There is not sufficient evidence to claim that budget support is more or less prone to corruption than project support.[13] It should also be noted that it is easier to detect corruption in project funding, but this does not mean that there is more of it. It is also easier to use project support to measure the outcome of a project and easier to identify and hold to account the relevant budget holders and project managers. Overall, the evidence tends to imply the need for caution and flexibility, and the use of a variety of approaches based on a corruption risk assessment.

What are the links between capacity building and corruption?

There is no solid evidence that capacity building is more prone to corruption than other types of activities funded in fragile states.[14] It is hard to evaluate the results of capacity building, because it involves a set of objectives that are difficult to measure: improving the knowledge and skills of civil servants, establishing new organisational systems in public administration, developing better policies and so on. However, the difficulty of measuring results does not in itself lead to increased corruption risks.[15]

The links between public administration and corruption are complex: the presence of corruption in the system can deter skilled and reform-minded individuals from working for the public administration. Corruption also makes it less likely that they are recruited in the first place: certain forms of corruption – primarily corruption in appointment systems, combined with an absence of "conflict of interest" rules for senior officials – mean that recruitment is often not based on merit. Yet without a critical mass of skilled, reform-minded individuals, institution building in fragile states will fail. In such states, reformers often choose to work for the private sector, international organisations and civil society instead of the public sector.

The use of non-state agencies to avoid corruption

Related to the question of *how* to fund – *i.e.* which aid approaches to use – is the question of *whom* to fund. When corruption in government agencies is thought to be widespread, donors often provide aid through other channels, including UN and other international organisations, international NGOs and local civil society. This may help reduce contextual corruption risks by supporting governance mechanisms, and can help reduce institutional

and programmatic corruption risks by supporting the delivery of services by agencies outside government control. Yet it may also make corruption worse by draining resources, including vital human resources, from the government.

Aid flows through UN agencies, international NGOs and civil society organisations may also be lost to direct corruption. Such aid is likely to reduce the external (contextual) corruption risk, but may pose other problems. Clearly, these organisations and their partners can also be corrupt and misuse or steal aid money. Here, as with corruption in government agencies, accountability and reporting mechanisms should be in place and activities should be rigorously evaluated. But these agencies can also play a role in combating corruption. In systems where there is much political corruption and limited political party development, civil society takes the place of oversight bodies that would otherwise be part of the political system – *e.g.* in monitoring government expenditure, drafting anti-corruption legislation, investigating corruption, and gathering and acting on complaints from the public.

Overall, the nature of non-state agencies, their absorption capacities, and the issues of risk and efficiency attached to funding through extended aid delivery chains (Box 4.6) mean that these agencies will only ever be a part of the picture. Most donors address this by developing multi-pronged strategies, which involve funding both government and non-state agencies in fragile states.

Box 4.6. **Corruption risks in the aid chain: the case of Somalia**

WFP, like other operational agencies in Somalia, has been forced to implement "remote management" arrangements that are dependent on local staff and partner organisations for the delivery of goods and services (see Box 3.1). Without continuous direct oversight of WFP operations, this approach was found by the Monitoring Group on Somalia to be highly vulnerable to fraud (UN, 2010). Al-Shabaab effectively demanded a price from aid workers trying to gain access to internally-displaced populations in areas under its control. Moreover, the Monitoring Group accused WFP's main delivery contractors of operating a price-fixing cartel. The extent of actual losses is contested: WFP ceased operating in Al-Shabaab areas in January 2010, and a subsequent independent audit found no evidence of wide-scale food diversion. What is not contested is that the risk of fraudulent activity was unacceptably high, and WFP has subsequently revised its own risk management procedures and has collaborated with the RC/HC's office to strengthen collective risk management among the various agencies operating in Somalia.

Risks attached to anti-corruption measures

Anti-corruption measures may conflict with other policies and principles that inform donor action, with "country ownership" being a case in point. Most OECD DAC donors have a strong commitment to local ownership, which has been expressed in both their own policy statements and DAC positions (Box 1.5). At first sight, anti-corruption measures undermine local ownership, because they imply closer control over spending by the donor, shifting power from the beneficiary government to the donor.

There are two main approaches to this dilemma:

1. Ensure donor oversight, where the donor "polices" the funding by imposing conditions.
2. Create local oversight, where oversight mechanisms are supported within the country but outside the central government, and checks and balances are created within the political system.

While donors have put in place far more rigorous conditions in the last 20 years (see above), they have not fully exploited this second approach. There has been a major increase in funding for anti-corruption and good governance work in the last 10 years (see the examples presented above), but these measures are not often directly linked to development assistance, tending rather to operate in parallel.

There are interesting examples of donor support for local oversight mechanisms, such as the work on budget transparency being carried out by the Ministry of Finance in Afghanistan. AusAid in Indonesia has developed another innovative way of strengthening accountability by strongly linking it to the capacity of the media and civil society to monitor government performance. Australia provides training to the media and civil society in order to empower them to analyse budgets, monitor implementation and improve investigative reporting skills. This approach has also been applied in Papua New Guinea through the Media Development Initiative (AusAid, 2007). Related efforts include strengthening oversight within the systems that AusAid supports in Indonesia and Papua New Guinea.

State capture and organised crime

A new and serious corruption risk is emerging in fragile states: transnational organised crime and its influence on the political system.[16] A key strategic question here is: if donors withdraw, does this create a vacuum in which organised criminal groups can flourish? This may be the case, but organised criminal groups have managed to establish a presence in many fragile states even while large flows of aid were going into the country. For example, in Guinea Bissau since 2004 (when stability returned following

the military coup of 2003), the European Commission alone has provided EUR 600 million in aid. Total development assistance to the country for this period is approximately EUR 5 billion.[17] Over the same period, however, there has been a dramatic increase in the influence of organised criminal groups, which are now believed to have infiltrated all governance structures in the country, creating a situation of state capture.[18]

In such a situation, state resources of all kinds are diverted to serve the interests of organised crime rather than those of the public. A nexus between organised crime and government officials develops, with those involved using the state's resources for their own ends, thus using the state as a vehicle to facilitate illegal activity or neutralising the state's power to tackle crime.

Tackling organised crime poses serious challenges for donors because of the number of agencies and activities that need to be involved. International and regional co-operation is deepening and country-specific initiatives are being closely monitored.

Cost-benefit of anti-corruption measures

For all anti-corruption measures, a cost-benefit analysis can be carried out. On the most basic level, this would ask the following questions:

- Are the costs of anti-corruption measures greater than the savings they produce?
- Is the reduction in corruption losses greater than the cost of implementing the anti-corruption measures?

While researchers have found many examples of savings made from particular anti-corruption measures, these savings are estimates and case specific. Other factors also have to be taken into account: spill-over benefits of anti-corruption measures, as described above, and indirect losses that would be generated by tolerating corruption in the aid system. However, on the other side of the equation, local procurement, even though it can provide scope for corruption, may offer benefits that should also be taken into account, and which will be covered below.

4.3. Local procurement: risk and opportunity[19]

One aspect of interventions in fragile states that underlines the interrelatedness of risk management approaches is that of procurement (Box 4.7). Procurement is a key element of almost all such interventions, perhaps with the exception of purely political engagement. Personnel and equipment have to be procured, and this is done according to different sets of rules and regulations, depending on who is doing the procuring. Procurement processes are particularly vulnerable to

risk, specifically fiduciary risk, but also the risk of programme failure when the procurement process is slow, cumbersome or faulty.

Box 4.7. **What is procurement and what risks does it raise?**

In this report, procurement is broadly defined as the process of identifying and obtaining goods, services, and works needed to carry out the operational and project objectives of development donors and their implementing partners. This includes all phases of contract administration, from acquisition to product or service delivery.

A typology of risks associated with procurement is provided in Annex C, based on the distinctions among contextual, programmatic and institutional risk.

In this section we focus on the particular issue of *local procurement*. The point is to highlight the balance that needs to be struck between *(1)* the need to limit exposure to the risks entailed in local procurement; and *(2)* the vital opportunity that local procurement presents to boost local economies.

Conflict and unforeseen disasters can ravage poor and fragile states, leaving people, infrastructure and resources devastated. While significant support in the form of both human and financial capital is often required from the international community for recovery and reconstruction, academic research and development experience both demonstrate the vital role that the local private sector can play in rebuilding the country and establishing peace. As an early driver of economic growth, investments in the domestic marketplace – particularly early on – can create or restore livelihoods while contributing to wider international objectives, including reducing the risk of renewed conflict (Collier, 2003).

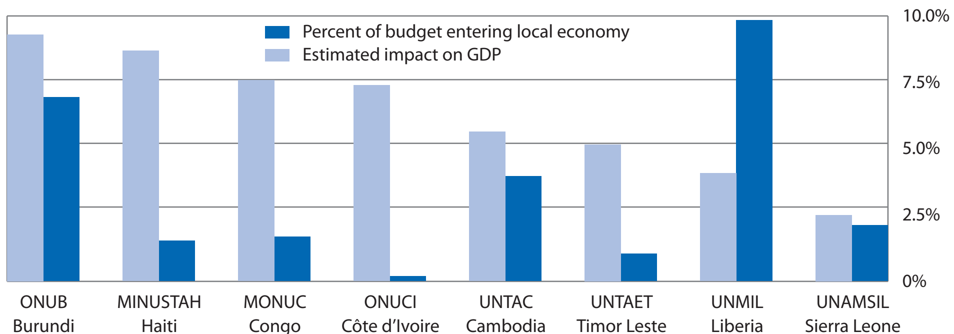
Awareness of these opportunities has led some agencies to take more risks during procurement. Yet the potential of local sourcing remains largely untapped because the international community has not made a concerted effort to confront the challenges and gaps in practice that could help manage and mitigate local procurement risk. Until these are addressed, the wider benefits of sourcing goods and services in countries recovering from conflict and disaster will not be fully realised.

Lack of experience and knowledge of local procurement, a process that can often go wrong, can mean that managers are reluctant to get involved in it until a reasonable level of stability has been established in a country in crisis. Past procurement practice, which has largely involved sourcing through international firms, has also made increasing local procurement in the post-conflict/post-disaster marketplace a difficult process.

The risks are real. The procurement policies of international agencies and actors often do not support local sourcing because of the risks associated with illicit activity, quality concerns, capacity, and perceptions about potential local economic damage that can result from hiring and buying at the country level. This unwillingness to engage with local economies is reflected in research, which shows that up to 80% of mission procurement can go straight out of the host economy – either to pay for imported goods or as profits to foreign firms who were awarded contracts (Carnahan, *et al.*, 2006). Figure 4.1 illustrates this for UN Department of Peacekeeping Operations (DPKO) expenditure.

This bypassing of the domestic private sector risks losing a key opportunity to begin generating the stability and self-sustaining growth needed for the host country to become independent of donor support.[20] This lack of engagement can undermine international efforts and pose risks to investments, project and operational objectives, and potentially even to national and regional security. In short, the (real) risks associated with local sourcing are not properly weighed against the potential short and long-term benefits of investing in local enterprises.

Figure 4.1. **How much of the UN's DPKO operating budget enters host economies?**



Notes: ONUB: United Nations Operation in Burundi; MINUSTAH: United Nations Stabilization Mission in Haiti; MONUC: United Nations Organization Mission in the Democratic Republic of the Congo; ONUCI: United Nations Operation in Côte d'Ivoire; UNTAC: United Nations Transitional Authority In Cambodia; UNTAET: United Nations Transitional Administration in East Timor; UNMIL: United Nations Mission in Liberia; UNAMSIL: United Nations Mission in Sierra Leone.

Source: Carnahan, M., W. Durch and S. Gilmore (2006), *The Economic Impact of Peacekeeping*, Peace Dividend Trust, New York.

Risks and challenges associated with local procurement[21]

In a stable free-market economy, procurement is associated with many risks that can jeopardise the reputation, finances and stability of both small and large companies. For the international community working to deliver humanitarian and development assistance in countries where infrastructure may be badly damaged, procurement risk is inevitably higher.[22] While adverse outcomes in procurement are not linked only to local sourcing, the perceived and real risks associated with procurement from the domestic market may deter institutions and personnel from taking advantage of opportunities to buy and hire at the country level. This includes, but is not limited to, security risks to personnel and beneficiaries, mismanagement/ waste of funds, risk to reputation, and project failure. The pressure on international organisations to spend resources quickly, the strain placed on procurement systems and personnel, limited oversight mechanisms, and the use of non-specialists to procure goods and services only make these risks worse (PricewaterhouseCoopers, 2009).

There are many contextual challenges inherent to these environments that aid initiatives do not sufficiently address, but which can adversely affect the ability of the local private sector to respond to the procurement process. This failure can limit economic growth and opportunities to reduce poverty, and thwart wider humanitarian and development objectives. These challenges include information asymmetry, insufficient capacity, a shortage of financing options, and projects or contracts that are too large in scale for new and emerging firms to manage.

The rest of this section outlines some of the primary risks associated with procurement in post-conflict and fragile states. Risks are considered from the perspective of both aid agencies and the private sector.

Managing procurement risk[23]

Introducing assessment tools that allow an accurate and realistic understanding of procurement risk can help identify potential risks and the probability that they will occur, determine how much local sourcing is possible, and allow aid organisations to generate contingency and management strategies to cope with or counteract risks as they arise.

However, interviews undertaken for this research and Peace Dividend Trust's operational experience both indicate that donors and agencies are generally not equipped to manage risk associated with procurement in conflict-affected and fragile states. In fact, in many cases, even when agencies had either informal or formal local procurement policies in place, representatives reported that risk was not yet being considered as part of the procurement process; or, if it was, approaches were very limited in scope and

chiefly related to limiting corruption. For example, a recurrent risk outcome was delay in delivery or the supply of low-quality products and services. In these cases, the risk mitigation strategy was to remove the supplier in question from the agency database.

While the international community needs to ensure it is delivering quality assistance and goods, this example reflects a lack of resources and planning to help mitigate common risks associated with local contracting while simultaneously strengthening the private sector's ability to supply the goods and services needed for the recovery and development effort under way in the host country.

In order to effectively manage risks associated with local procurement, donors and implementing agencies must be equipped with the tools to identify and evaluate risks, the capacity to manage those risks properly, and the ability to monitor and respond to risks (both planned and unplanned) over a project's life cycle. This can greatly contribute to a project's success, particularly when it starts at the planning stage.

UNDP's ERM framework aims to provide a more collective and proactive response to risk management by consolidating its knowledge, procedures and tools, and mainstreaming risk management principles across the organisation. The ERM framework includes policies for specific operational areas, including procurement. While not specific to local procurement, this framework provides a good example of the stages of the risk management cycle and examples of how procurement risks may be mitigated. Table 4.1 provides examples of how to manage and mitigate specific risks related to sourcing.

Incorporating risk assessment tools that allow for an accurate and realistic assessment of procurement risk would also help determine appropriate levels for local sourcing. For example, in some UN peacekeeping missions, the Supply Positioning and Risk Evaluation Matrix[24] is used to establish the "low cost, low risk" categories of procurement budgets (UNAMID, 2008) in order to identify the goods and services that can likely be procured locally in order to support local economic development and minimise the potential negative impacts of a mission (*e.g.* supply delays, lack of quality). This provides the opportunity for procurement resources to be allocated against intended objectives according to the level of risk (UN, 2006). Furthermore, this strategy takes into account the capacity of local businesses by allowing companies to compete for new opportunities in specific sectors.

In addition to making risks more manageable for the international community, stepping-stone approaches like these can allow businesses to participate in aid efforts at the early stages of an intervention. This offers local companies the opportunity to grow and acquire the knowledge and skills needed to operate in the local marketplace far beyond the reconstruction and development process, helping to ensure sustainable outcomes.

Table 4.1. **Managing procurement risk**

Sourcing		
Risk factor	Possible outcome	Possible solutions
Wrong approach to the market	Inadequate or inappropriate supplier response Higher prices Selection of inappropriate approach Limited competition	Analyse the supply market Develop sourcing strategies
Misrepresentation of facts by potential suppliers	Signing a contract with unsuitable companies Claims of unethical or unfair dealing Breach of contract	Independently verify suppliers' qualifications Conduct supplier reference checks and due diligence
Outdated information on potential suppliers	Inadequate supplier response Limited competition	Maintain suppliers roster
Placing of procurement notices in inappropriate media	Lack of sourcing strategy Limited competition Contract with unsuitable companies	Identify relevant media to post procurement notices

Contextualising the approach

Faced with the limited development of the local private sector, donors can use a number of procurement methods that take into account the specificities of local markets and their associated risks. For example, in Afghanistan USAID has decided to limit the size of its contracts due to inefficiencies in the implementation of large contracts, including slow start-up and project delays.

WFP's Purchase for Progress (P4P)[25] programme takes a similar approach. P4P, which is currently being piloted in more than 20 countries, buys excess production from local farmers. Its objective is to develop the ability of small farmers to supply agricultural markets, increase food security over the long term and contribute to income generation. Within P4P, WFP has adjusted its procurement methods to remove barriers that prevent small farmers from becoming regular suppliers, including reducing minimum quantities to be supplied, removing the need for guarantee bonds and providing training.

This pilot programme allows WFP to test new mechanisms and approaches that improve the local economy while simultaneously carrying out the organisation's mandate of fighting hunger. By using a pilot format, WFP is able to innovate without affecting traditional programming, and will be able to integrate properly tested policies and procedures into its future programmes.

Managing and mitigating risks associated with emergency procurement

Because local procurement in post-conflict/post-disaster contexts is generally categorised as "high risk", donors and agencies need ways of weighing the risks against the opportunities involved in making their decisions (Box 4.8).

UNDP's Fast-Tracking Strategy, developed by the Bureau of Management and the Bureau for Crisis Prevention and Recovery, provides a good example of this (UNDP, 2009). This strategy enables country offices to respond more quickly to crises and emergencies while improving the efficiency and effectiveness of the agency's response. In particular, fast-tracking deals with situations where UNDP must willingly and knowingly increase its exposure to risk for a specific purpose. This approach to programming allows the organisation to consider the risks involved in proceeding with a particular response in light of the opportunity costs of not doing so. In regard to local procurement, the fast-tracking approach seeks to transform UNDP from a risk-averse organisation to one that balances risk and opportunity in its

Box 4.8. **Balancing risk and opportunity**

According to the UNDP, "The prevailing risk management approach is one where risk is seen as: *(a)* something that the organization is subjected to by outside forces; *(b)* a bad thing that needs to be mitigated at all costs; and *(c)* something described as 'too risky.' The only way to rationally discuss the notion of 'taking risks' and risk appetite is to also account for the positive alter ego of risk, which is 'opportunity'" UNDP (2009).

For example, "… if we skip competitive bidding in a particular procurement case, we risk renting 20 trucks for a higher price than absolutely required (risk magnitude = 20 trucks at a possible rate differential of [USD] 50 per day for 30 days = [USD] 30 000). On the other hand, if we go through an open competitive bidding, we may lose a significant opportunity to clean up the coastal areas very quickly and position UNDP as a major actor in tsunami recovery and reconstruction and reconciliation because, by tomorrow, all trucks will already have been rented by others or redeployed elsewhere."

Source: UNDP (2009).

decision-making processes, which will allow it to analyse the context in which it is operating to ensure that functions such as local sourcing are used effectively.

By accepting a higher tolerance for risk where an opportunity is identified, UNDP believes it can increase both its own efficiency and the effectiveness of the response – in essence, doubling its impact. UNDP is in the early stages of testing this new initiative and therefore strategy and implementation are still being shaped. In Haiti, where fast-tracking has been used (Box 4.9), agency personnel found that they did not yet have the capacity on the ground

Box 4.9. **WFP and the Haiti earthquake**

The emergency situation following the earthquake in Haiti of 12 January 2010 led WFP's Finance Department to grant a special dispensation to refugee camp managers that permitted them to bypass a number of WFP's procurement policies in order to employ suppliers of fresh produce as quickly as possible. This allowed camp managers to:

- source four local suppliers;
- select the best supplier from among them; and,
- pay for the goods on delivery.

Normally, WFP's standard procurement procedures mitigate the risk of procurement irregularities by ensuring that each step of the procurement process is carried out by a separate WFP entity:

- sourcing of providers is done by WFP's Procurement Department;
- the winning supplier is selected by a separate procurement committee; and,
- payment is made by WFP's Finance Department 30 days after the goods are received.

In light of the emergency situation, WFP's Finance Department decided to waive these processes by allowing WFP camp managers to source, select and pay the local supplier. In other words, it accepted the exposure to risk as a trade-off so that WFP could act quickly in an emergency situation.

When doing this, camp managers mitigated risks by consulting the appropriate WFP stakeholders and keeping a detailed record of all transactions with each supplier in order to ensure transparency and allow future auditing. Suppliers were eventually given a formal WFP contract incorporating the organisation's standard risk management procedures.

to manage some of the increased risks associated with higher volumes of procurement. To address this, flexibility was increased for smaller purchases (*i.e.* the amount defining such purchases was doubled from USD 2 500 to USD 5 000); while for larger procurements the traditional three-stage approval process between headquarters and the field was reduced to one approval in the field and one at headquarters level.

Being able to access goods and services in an emergency is essential to saving lives. Hiring emergency personnel – including procurement officers – with the necessary experience, training and knowledge of the local environment is therefore essential. This can help ensure that risks and opportunities are properly weighed and risks associated with mismanagement and corruption are reduced, all of which contribute to efficient outcomes.

Notes

1. This is a vast topic; we can only highlight here a few of the features that may be most relevant to the aid sector, particularly in its dealings with fragile states.

2. Price risk management of this kind is increasingly being used in developing countries to deal with commodity price volatility. See, for example, the work of the Commodity Risk Management Team at the World Bank.

3. Taken from Wikipedia, accessed 22 September 2010. However, there are many variations of this definition.

4. Most attempts to measure corruption and compare levels of corruption in different countries show that corruption is particularly high in fragile states (World Bank, http://info.worldbank.org/governance/wgi/index.asp; Transparency International (2009); Freedom House, n.d.).

5. For more information, see *www.entwicklung.at/uploads/media/Focus_Combating_Corruption_September_2009.PDF.*

6. See DFID online document *Tackling corruption in the world's poorest countries*, available at *www.u4.no/document/showdoc.cfm?id=150*, accessed 28 May 2011.

7. See "Norwegian Development Assistance in 2008 – Priority Areas", Norwegian MFA website, *www.regjeringen.no/en/dep/ud/selected-topics/development_cooperation/norwegian-development-assistance-in-2008.html?id=493308*, accessed 28 May 2011.

8. See *www.transparency.org/global_priorities/public_contracting*, accessed 28 May 2011.

9. Managing the corruption risks associated with aid provided through non-state agencies is in part covered by the fiduciary risk management discussion in section 3, but this topic deserves fuller coverage than space permits in this report.

10. Norad budget support web page, accessed 3 May 2011: *www.norad.no/en/Thematic+areas/Macroeconomics+and+public+administration/Budget+support/Budget+Support.124431.cms?show=all.*

11. See OECD DAC webpage: *A Joint Evaluation of General Budget Support 1994-2004, www.oecd.org/document/51/0,3343,en_21571361_34047972_36556979_1_1_1_1,00.html*, accessed 29 May 2011; as well as DFID (2007).

12. See U4 web page: *www.u4.no/themes/pfm/main.cfm#aidmodalities*, accessed 3 May 2011.

13. There is insufficient evidence in the public domain, at least. There may be more information that donors do not make available about the prevalence of corruption in project support.

14. "Capacity building" here refers largely to technical assistance aimed at developing the capacity of government institutions. Overall, 21% of aid from OECD DAC countries is spent on technical assistance.

15. There is a body of evidence showing that large-scale construction projects are very prone to corruption, yet in these cases the intended results are tangible (solid) and measurable, *e.g.* has a stretch of road been built or not? (Transparency International, 2007)

16. Misha Glenny's work of investigative journalism, McMafia (Glenny, 2009), looks in detail at the global nature of organised crime and its destabilising effects. The states/areas he covers include South Africa, North Korea, the Balkans and Afghanistan.

17. This is a rough estimate based on published figures from key donors to Guinea Bissau.

18. The UN has raised the concern that Guinea Bissau is at risk of becoming a "narco-state".

19. This section presents a condensed version of the analysis and conclusions in a longer paper by the Peace Dividend Trust (PDT) on risk and local procurement. See World Bank (2010).

20. Interviews with respondents.

21. Many of these risks have been reported to the Peace Dividend Trust through donor and agency interviews, supplementary research, and other operational experience. The risks are discussed in direct relation to local procurement. Detailed studies of corruption in fragile state environments were also consulted, but very little literature exists specifically on local procurement.

22. See, for example, Transparency International (2009).

23. The PDT paper cited above (World Bank, 2010) presents a fuller review of existing approaches and other suggested methods for procurement risk management.

24. The Supply Positioning and Risk Evaluation Matrix is a software tool that categorises expenditure into four different quadrants that provide a profile of an organisation's procurement activity.

25. See *www.wfp.org/purchase-progress*.

Chapter 5

Conclusions and recommendations

This chapter sets out conclusions and recommendations for DAC donors in particular, and for the organisations that they fund. It lists five main findings: (1) *Donors are unduly risk-averse in their aid engagement in fragile and transitional contexts.* (2) *Lack of shared risk analysis concepts and frameworks is hampering effective collaboration on risk management.* (3) *The pressure to demonstrate narrowly defined results and accountability requirements is making donors and their implementing partners more risk averse.* (4) *Current approaches to controlling corruption and other fiduciary risks are stifling effectiveness.* (5) *There are not enough collective approaches to managing risk or well co-ordinated donor strategies of engagement. For each of these points practical recommendations are made, mainly concerning the need to establish a risk culture and related processes which encourage appropriate risk.*

We began this study by asking whether international aid donors are too risk-averse in fragile and transitional situations. In other words, are they unwilling to run the kind of programme and institutional risk necessary to deal with contextual risks effectively, or to seize opportunities to promote positive change in these environments?

Being prepared to take greater risk implies a willingness to accept the consequences if things go wrong. The tolerance for error appears to be less than it used to be, and errors are now highlighted. Risk perceptions can only be managed to a limited extent. Part of the answer to this is to involve overseers – from parliamentarians to auditors – in the process of agreeing appropriate risk parameters for these high-risk interventions. We have reviewed some mechanisms (*e.g.* the OTI in the US and START in Canada) where this is already happening, but they seem to be the exception rather than the rule. One of the conclusions of this study is that the question of risk has to be addressed more explicitly and transparently by policy makers *before* any challenges arise, rather than afterwards. This does not mean having policies that contain a high tolerance of risk outcomes; but rather policies that accept a high degree of exposure to risk under certain circumstances, along with appropriate risk parameters and accountability requirements.

One point on which interviewees were unanimous is that a risk-opportunity balance has to be struck: exposure to institutional or programme risk *versus* the opportunity to reduce external risk (*e.g.* by achieving political breakthrough). This boils down to deciding whether the risk of not acting in a particular situation is greater than that of acting. In addition, the risk of a single country not acting is much harder to argue than the risk of a *collective* failure to act (as with climate change). DAC donors could address this through more concerted approaches to risk analysis and risk management.

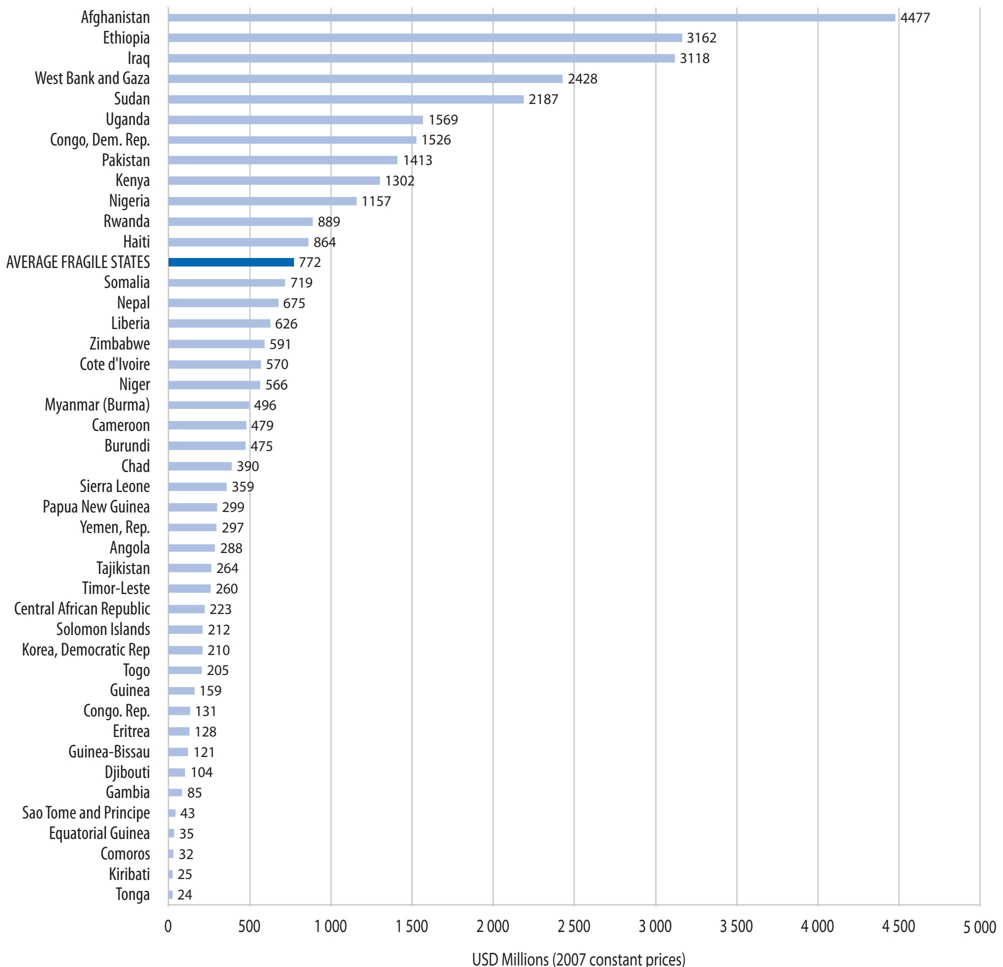
Overall, we conclude that current donor behaviour and systems are too risk-averse, in a range of ways, to achieve the desired results. The specific findings of the study can be summarised in six main conclusions that were found to hold broadly true across the range of donor policies and approaches that we examined, and were also considered true by the great majority of those consulted. These are set out below, along with related recommendations for DAC donors.

1. Donors are unduly risk-averse in their aid engagement in fragile and transitional contexts

Donors tend to be risk-averse in *where* they engage. Although they have been willing to invest large amounts in high-risk environments of particular strategic concern like Afghanistan and Sudan, this has been highly selective (Figure 5.1). Donors also tend to be risk-averse in *how* they engage. Dominant political and security agendas tend to dictate the scale of aid operations

and seem to permit those involved to run more aid risks, but the traditional approaches and standard operating procedures implemented today are often poorly adapted to fragile and transitional contexts, and there are (in practice) few incentives to innovate or otherwise take risks. For more effective aid in situations of transition, donors need to change their individual and collective behaviour, allowing their implementing partners greater flexibility. This requires leadership from the top, a culture of frank and open discussion between managers and staff, and a willingness of senior managers to back (indeed,

Figure 5.1. **The highly concentrated nature of aid to fragile states, 2008**



Source: OECD (2010), *Resource Flows to Fragile and Conflict-Affected States*, OECD, Paris.

to reward) those who take appropriate risks within agreed parameters. Any such shift, however, requires that managers remain confident of their ability to retain sufficient control. The examples of special units (Chapter 3) established by donors to deal with transitional and high-risk environments appear to be an effective way of creating a limited firewall between the institution and its more high-risk activities. At the same time, funding and finance mechanisms need to be adapted to fund such high-risk activities in ways that allow rapid response to the needs of fragile and transitional situations.

Recommendations

a) Establish a risk culture and related processes which encourage appropriate risk

- Donors should review their working culture and incentive structures relating to organisational goals and the behaviour they expect of staff when engaging in fragile or transitional settings.
- Specific risk management frameworks should be developed for fragile and transitional contexts.
- Donors who cannot make exceptions to their standard procedures should create special units to deal with transitional and high-risk environments – or special funds – that are governed by more flexible rules and procedures.

b) Establish appropriate funding and finance mechanisms

- Use more flexible types of multi-donor trust funds (MDTFs) that reduce transaction costs and increase disbursement speed without compromising their essential role.
- Donors need to involve national non-state actors in peacebuilding and statebuilding processes, while at the same time acknowledging that granting funds to national non-state actors comes with higher risk and oversight costs. Funding mechanisms should be structured to support this (*e.g.* by establishing a capacity development window).
- Donors should be prepared to pay the additional costs of managing funds and programmes in difficult environments. Such context-specific costs should be separately budgeted or else covered by an increased overhead budget line.
- Donor leadership and joint planning are needed to allow apparently contradictory strategies (*e.g.* sectoral budget support and direct service provision through NGOs) to be made complementary.

2. Lack of shared risk analysis concepts and frameworks is hampering effective collaboration on risk management

Faced with a multitude of frameworks and inconsistent terms and concepts, it is hard to compare approaches across or even within organisations. This hampers effective collaboration on risk management. Most management frameworks in use are not well adapted to the challenges of managing risk in fragile states. There is some evidence of change here, such as the adoption of specific enterprise risk management and portfolio risk management approaches that attempt to balance risk exposure within and across programmes, but this needs to be extended.

Recommendations

a) Agree on concepts and terminology

- Donors should agree standard defined terms and categories for aid-related risk.
- Documents should distinguish between risk *outcomes* and risk *factors.*

b) Strengthen the use of joint assessment and analysis

- DAC donors working in a given context should aim to adopt common contextual risk analysis tools.
- DAC donors in all fragile and transitional contexts should establish a process of joint contextual risk analysis as a basis for harmonised approaches.
- Risk analysis should be made a more central component of needs assessment, with the link between contextual and response analysis made more explicit in terms of risk reduction.

3. The pressure to demonstrate narrowly defined results and accountability requirements are making donors and their implementing partners more risk averse

Risk-averse behaviour manifests itself in many ways: conservative selection of programme approaches (a mistrust of the unconventional or untested); a tendency to work in “safe” areas where results and full accountability can be ensured; and a tendency to discourage devolution of control and local initiative. If donors are genuinely concerned with outcomes rather than just outputs, this trend needs to be reversed. Current accountability expectations are often unrealistic in fragile and transitional contexts, which can lead to problematic results. There needs to be a more appropriate balance between control and flexibility. Either generic standards need to be applied in more flexible ways,

allowing explicit exceptions to reporting and other requirements case by case; or alternative standards need to be devised for these contexts, allowing for diverse contexts. This requires dialogue and agreement in advance among controllers, programme managers and partner organisations; and adaptation to changing circumstances.

Recommendations

- Objectives and criteria for measuring "success" need to be more realistic. In particular, donors need to reassess the way in which "success" and "failure" are understood in their organisations, and recognise that intelligent, responsive programming may lead to results that are hard to categorise in either way – and that may also be hard to quantify. DAC donors should be less tolerant of "built-in" programme failure.
- Specific frameworks are needed to measure results in difficult environments, including methods that reduce known risk factors.
- Donors' financial procedures should be more flexible in fragile and transitional contexts. Particular attention should be given to the rapid transfer of funds and conditions for disbursement.
- Donors should establish more realistic expectations for the level and detail of financial reporting in fragile and transitional contexts.
- Donors should tailor their outputs and outcomes reporting to the circumstances of fragile and transitional contexts and accept that "full" accountability may be impossible to achieve.
- Better funded and more effective monitoring and evaluation (M&E) methods are needed for fragile and conflict-affected environments. This should include investigating the impact of aid on the wider context.

4. Current approaches to controlling corruption and other fiduciary risks are stifling effectiveness

Zero tolerance policies on corruption are the norm for most donors. But working in fragile contexts inevitably involves a higher degree of exposure to corruption and the misuse of aid. Attempts to control corruption risk through tight, centralised financial controls can unintentionally reduce programme effectiveness. Although delegated control (including spending authority) may expose the institution to higher fiduciary risk, it is often crucial for effective and responsive engagement in volatile and rapidly changing environments.

There is a difference between accepting exposure to risk and tolerating risk outcomes. While operating in these environments may entail a higher degree of exposure to institutional risk than normal, it is still incumbent on responsible organisations to minimise that risk through appropriate risk management measures – including monitoring and investigation of abuse.

Recommendations

- In each fragile state, donors should develop common positions on corruption in order to increase institutional leverage.
- As a general rule, donors should be prepared to run the relatively higher fiduciary risks associated with local procurement to help achieve local economic, social and political benefits.

5. More collective approaches to managing risk are needed, along with better co-ordinated donor strategies of engagement

Whatever the approach of individual donors to risk management, perhaps the greatest risk factor of all is the failure to co-ordinate their strategies. The likely result is collective failure to tackle the main contextual risks that justified the cost of engagement in the first place.

Evidence from Uganda and Nepal suggests that concerted donor approaches to risk management work better than bilateral approaches. While the overall risks of aid engagement probably cannot be much reduced, the exposure of individual donors can be. Donors have increasingly used pooled funding mechanisms like the MDTF for risk sharing. Individual donor exposure to risk is to some extent diluted by these mechanisms, but as currently designed they share many of the same problems as the bilateral mechanisms, with the added complication of having to satisfy multiple stakeholders. Working through trusted partners may reduce risk, although the transfer of risk to implementing partners may simply relocate tensions.

Recommendations

- Donors should maximise their collective impact on contextual risk and facilitate risk burden sharing or the pooling of programme and institutional risk.
- Donors should ensure that pooled funds create greater strategic coherence and shared ownership of a common plan, and are underpinned by predictable and flexible funding.

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Annex A

Bases of risk analysis

Risk is a relative concept. We have to ask "risk of what, to whom?", which requires among other things ways of determining the vulnerability of different groups or institutions to a particular kind of threat. The relative aspect of risk is reflected in the formula commonly used in disaster management: risk = hazard x vulnerability. This serves to illustrate that establishing how *great* a risk is gives only one kind of information. It is another thing to ask "what are the causal factors – and how can we influence them?" In the event of a disaster, we may be able to do little about the hazard, especially if it is a natural phenomenon rather than a human-made one. But we may be able to reduce people's vulnerability to the effects of earthquake, floods, etc. It is the *effects* of these events, not the events themselves, that constitute the disaster.

In practice, much risk analysis takes a more narrative form, typically involving the formulation of potential *scenarios* as a basis for planning. Although the future is uncertain, we can to some extent manage that uncertainty by predicting the possible courses of events and then ensuring that we are ready to respond to whichever scenario actually occurs. This is far from being an exact science, but the greater the understanding of a given

Box A.1. **Risk and uncertainty**

Risk and uncertainty are linked, but should be distinguished. Uncertainties are sometimes classified as being either aleatory, where uncertainty arises because of a natural and unpredictable occurrence, or epistemic, where uncertainty arises due to a lack of knowledge about the behaviour of the system. This distinction is significant in that the former is irreducible, and the latter, through sufficient study and expert knowledge, is reducible

Source: Daneshkhah (2004).

context and the factors that drive it, the more likely it is that the scenarios considered will cover the range of possible outcomes – and that we will choose a realistic basis for planning. We may choose to plan on a "worst-case" or a "most likely" scenario basis. Either way, risk analysis and risk judgement are built into this kind of decision making more or less explicitly. We may, for example, feel that we need not plan on a "worst-case scenario" basis, either because we judge it highly unlikely or else we judge it a risk worth taking and one we can afford to take.

A common form of quantitative analysis, particularly in the public sector, is cost-benefit analysis. This is a way of testing the cost effectiveness of different alternatives to see if their benefits outweigh their costs. For our purposes, in thinking about how to apply this kind of analysis in the case of aid intervention in fragile states, the key question is what exactly to weigh in the scales on each side of this equation. How do we establish the benefit of policies or programmes whose results may not be known for years, if they are known at all? We also have to recognise that the cost side of the equation involves more than financial costs, and that some (*e.g.* political) costs may be unacceptable, whatever the anticipated benefit. In short, cost-benefit analysis plays a useful but limited role in risk analysis of the kind we are concerned with. In the words of the UK Select Committee on Economic Affairs (2006) report on risk management, "[c]ost-benefit analysis provides a useful framework for thinking about risk policy, but costs and benefits are often uncertain or difficult to measure and it is important to recognise the limitations of quantitative approaches to risk assessment."

Annex B

Some policy dilemmas of intervention in fragile contexts

Below we discuss some of the most obvious dilemmas decision makers might face when contemplating supplying aid to fragile contexts. Given the complexity of these situations, this list makes no claim to be exhaustive.

Speed *versus* effectiveness

One of the basic dilemmas is the challenge of intervening both rapidly and effectively. Some believe that far from being in tension, effectiveness *demands* quick action in fragile contexts. So, for example, the European Commission notes that "… dealing effectively with fragility involves taking risks and requires rapidity and flexibility in adopting political decisions and making them operational in the field, while dealing simultaneously with partner countries' constraints – often in terms of limited capacities" (European Commission, 2007).

Short-term *versus* longer-term priorities

The dilemma of having to act effectively in the short term while designing interventions that have positive long-term impacts can be a particularly difficult one. If donors concentrate exclusively on long-term institution-building objectives without addressing the urgent need to deliver basic services, there is a risk not only of failing to meet the people's most basic needs, but also of causing political and social instability, and undermining the government's leadership. Yet too great a focus on immediate service delivery can undermine longer-term processes. The phasing and sequencing of agendas necessary for successful transitions (noted above) pose major strategic challenges.

Externally-provided *versus* government-provided services

Effective short-term interventions often rely on parallel mechanisms and do nothing to boost the capacity of the host government. Where there is little or no government capacity, it is often quickest and easiest to use parallel mechanisms to support delivery, usually international NGOs or UN agencies. The pressure for quick results may lead donors to prioritise service delivery over capacity building; but in the long run, the use of parallel mechanisms may reduce the capacity of the local government by absorbing skilled staff and crowding out state functions. Creating parallel institutions and systems also risks undermining the authority, ownership and legitimacy of regular government ministries. Most donors attempt to resolve these tensions by using some kind of hybrid approach, locating service delivery within a government-owned plan, and finding ways to build state ownership and accountability over time.

Harmonisation and alignment with country policies and systems

As noted above, the lack of harmonised approaches to the various agendas being addressed by donors in fragile states creates a serious risk of incoherent strategies being formulated, resulting in the collective impact of an intervention being less than the sum of its parts. But in fragile situations, several obstacles to policy alignment arise, notably the (perceived) lack of adequate policies with which to align, or the existence of multiple policy frameworks with uncertain political commitment. Donors must make sensitive choices about alignment in such cases.

Donor harmonisation *versus* speed and flexibility

Related to the previous point is the potential trade-off between donor harmonisation efforts and the need to act quickly and flexibly in transition situations. While the use of multilateral funding channels (the UN, the World Bank) promotes harmonised approaches, the related mechanisms such as pooled funds can be cumbersome and slow – partly as a result of the fiduciary requirements of the donors themselves (see Section 3.3 of this report). Other mechanisms for donor harmonisation are often weak or absent.

Fiduciary risk management *versus* flexible use of funds

Financial management in fragile and transitional contexts needs to be flexible to permit the rapid reallocation of funds to address changing needs and adapt to rapidly changing circumstances. But this may go against normal

planning processes and timetables, and appears to be frequently at odds with standard procedures for controlling funds. Working in fragile and transitional contexts may require much more authority to be delegated to field personnel, resulting in risks from lack of central control and oversight. This raises issues of trust, accountability and "pre-sanctioned" risk-taking.

Implementation and operational risk management

Donors and their partners face many operational risk factors in fragile and transitional contexts, since these contexts are often characterised by insecurity, volatility, poor infrastructure, and weak human and logistical capacity. A major risk factor is the security threat to staff and partners. This not only limits what it is possible and appropriate to do, but presents considerable obstacles to implementation and increases costs. Determining the right risk-benefit and cost-benefit balance is difficult in these circumstances, and one's approach is likely to change as needs and contextual risks change with time.

Donor staffing and institutional memory

It is clear from the interviews conducted for this study that sufficient staff capacity, both in terms of numbers and qualifications, is vital to effective programming and avoiding institutional risk. Many respondents stressed the difficulty of recruiting and retaining staff in these environments. Shorter tenures lead to loss of institutional memory, which can in itself result in programme failure. The fact that donors are committed to increasing aid to fragile states while decreasing their own institutional capacity and staff further adds to this challenge.

Monitoring, evaluation and programme review

Monitoring and evaluation in fragile and transitional settings presents particular challenges. These relate to the difficulty of indentifying the right indicators for a number of objectives; the difficulty of collecting accurate and reliable data; and the pressure to achieve results, particularly when large volumes of aid are being channelled. Intense political and public interest in post-conflict situations influences the level of resources; the time pressures; and the sensitivity associated with monitoring, evaluating and reporting. In countries like Afghanistan and Haiti, the technical task of performance monitoring risks becoming entangled with (and distorted by) reporting pressures, public relations activities, and the need to show short-term results in long-term processes.

Accountability and programme scale-up

In fragile states, basic accountability systems between state and citizen are generally weak, if not non-existent. There is a risk of creating an accountability vacuum in which neither external service providers nor the government takes responsibility for performance. Methods need to be found to allow both to be held accountable, sharing both the risk of failure and credit for success. Donors, for their part, may be unable to provide the evidence of success necessary to justify an increase in financial support. NGOs often settle for small-scale operations rather than developing systems capable of providing large-scale support.

Annex C

A typology of corruption-related risks

Contextual risks

- Political corruption (electoral fraud including vote buying; corruption in campaign and party finances, including illicit flows of money from corporate sector and organised criminal groups, buying and trading in influence etc)
- Corruption in appointment systems
- Theft of state resources
- State capture
- Corruption in natural resource management
- Trafficking/smuggling (in people, drugs, weapons, natural resources, counterfeit products, etc)
- Bribery of state officials and politicians
- Corruption in the legal system (meaning that contracts and property rights cannot be enforced)
- Corruption in procurement (government budget, which may include a large percentage of aid money) (collusion among bidders, awarding of contracts based on connections rather than the merit of bids prepared, deliberate over-estimation of work required, over-billing, etc.).

Sectors in fragile states that are likely to be affected by corruption

- Security sector, law enforcement, political system, border and customs agencies.

Related risks

- Money laundering

Programme risks

- Aid money stimulates a pattern of corruption, *e.g.* starts the practice of and leads to the systems for the theft of state resources
- Corruption in appointment systems (*i.e.* aid is funding salaries and thus positions in the public administration or within project become more appealing; individuals bribe or trade their way into these positions)

Institutional risks

- Theft and diversion of aid (siphoning off of aid money by officials, politicians and project implementers)
- Misallocation of aid (*i.e.* it is allocated to low priority area because of private rather than public interests)
- Corruption in project selection and project design
- Ghost expenditure (funding is allocated to projects that do not really exist or on salaries of non-existent workers)
- Corruption in procurement (aid money) (collusion among bidders, awarding of contracts based on connections rather than the merit of bids prepared, deliberate over-estimation of work required, over-billing etc)

Fraudulent accounting

Related risks (these risks are not types of corruption but may either result from corruption or facilitate it)

- Money laundering
- Reputational damage
- Loss of public support for development
- Cuts in development budgets

Annex D

List of interviews

Australia

Matthew Fehre – Director, Working in Partner Systems (WiPS) section

Christina Landsberg – Acting Director, Crisis Prevention, Stabilisation and Recovery Group

Mat Kimberley – Group Manager, Crisis Prevention, Stabilisation and Recovery Group (CPSRG)

Lyndal Manson – AusAID representative at the Australian Embassy in Paris

Canada

Kumar Dalvi – Principle Analyst, Integrated Risk Management & Performance Management Director/Defence Strategy Management (DDSM 4-9)/Chief of Programs (VCDS/C Prog) (National Defence)

Wes Darou – Team Leader, Integrated Risk Management/Strategic Policy and Performance Branch (CIDA)

Elissa Golberg – Director General, START

Dana-Mae Grainger – Director/Strategic Planning and Resources Division (DFAIT)

Xiang He – Policy Analyst, Peace, Conflict and State Resilience/Policy Development Division – Strategic Policy and Performance Branch (CIDA)

Angela Keller-Herzog – Manager, Fiduciary Risk and Practices Development/Chief Financial Officer Branch (CIDA)

Sharon Messerschmidt – Director and Chief Audit Executive/Risk Management and Internal Audit (IDRC)

Tshome Nkruma – START Corporate risk management

Gerd Schönwälder – Director, Policy and Planning Group/Corporate Strategy and Regional Management Branch (IDRC)

Pegatha Taylor – START

Sarah Woolhouse – START

Denmark – Ministry of Foreign Affairs

Søren Davidsen – Technical Advisor – Governance

Lone Dencker Wisborg – Under-Secretary of State for Global Security

Peter Ellehøj – Deputy Head of Dept. Quality Assurance – Development Cooperation

Rolf Holmboe – Head of Department of Stabilisation

Christian Krone Jørgensen – Special Advisor Quality Assurance – Development Cooperation

Finn Nielsen – Senior Technical Advisor – Fragile States

Ib Petersen – State Secretary for Development Policy

Trine Rask Thygesen – Deputy Head of Department Humanitarian Action, Development Policy and Civil Society

Tania Schimmell – Head of Section – Conflict and Fragility, Department of Stabilisation

Sus Ulbæk – Under-Secretary of State for Regional Affairs

European Commission

Marc van Bellinghen – DG RELEX

Isabelle Combes – DG ECHO

Brontë Flecker – Europe Aid, Chef de file Fragile States

Petra Gombalova – DG DEV desk Sierra Leone

Laura Gualdi – DG AIDCO, transition

Isabelle Richard – DG DEV desk Zimbabwe

Dorothee Starck – DG DEV PanAfrican Issues and Institutions, Governance and Migration

Germany

Klaus Schreiner – GTZ

Martina Vatterodt – Desk Officer, BMZ Emergency Aid and Transitions Department

The Netherlands

Ronald Wormgoor – Senior Policy Officer Peacebuilding and Stabilisation Unit, MFA

UK – Department for International Development

Rebecca Dale

Jack Jones

Rurik Marsden

Mark Segal

Ajay Sharma

Mike Smithson

Alex Stevens

Sweden – Ministry of Foreign Affairs

Anna Jakenberg-Brinck – Department for Management of Development Co-operation

Mikael Lindvall – Deputy Director, Department for Security Policy

Lena Sundh – Ambassador, Humanitarian Team, Department for Security Policy

Silvija Tolomanoska – Department for Security Policy

Sweden – Sida

Hazme Akyol – Country Team Iraq/MENA region

Begona Birath-Barrientos – Regional Latin America/Nicaragua

Ylva Blondel – Humanitarian Team (Zimbabwe, OCHA)

Per Byman – Director Humanitarian Team

Rolf Carlman – Country Directors occupied Palestinian Territories

Sofia Dohmen – Policy Specialist, Gender Team

Jesscia Eliasson – Department for Human Security (Colombia, Uganda)

Göran Engstrand – Country Director Zimbabwe

Patrick Kratt – Humanitarian Team (ICRC, DRR)

Katarina Koglou – Department for Evaluation

Anders Hagwall – Country Director Afghanistan

Francois Landiech – Humanitarian Team (DRC, Burundi)

Eva Lövgren – Country Director DRC

Hans Magnusson – Director Department for Conflict and Post-conflict Countries

Anna Maria Marta – Controller

Kerstin Nordvaller – Controller

Eva Nunes Sörensson – Country Director Guatemala

Helen Rask – Country Director Iraq

Karin Rohlin – Country Director Regional Latin America/Nicaragua

Helena Sancho – Country Team Bosnia-Herzegovina

Cecilia Scharp – Country Director Sierra Leone

Petra Smetmanis-Dry – Country Team DRC

Torgny Svennungsson – Country Director Colombia

Pernilla Trägårdh – Department for Human Security (Colombia, Uganda)

Maria Thorin – Humanitarian Team (Haiti)

Gunnel Unge – Humanitarian Team, Afghanistan, Pakistan

Erik Wallin – Country Director Liberia

USAID

Rachel Locke – Office of Conflict Management and Mitigation

Yvon Resplandy – Adviser for Diaspora and Remittances

Kirby Riley – Office of Conflict Management and Mitigation

United Nations Development Group

Sally Fegan-Wyles – Director of the UNDG, and former PBSO

Gordana Jerger-Associated Director Crisis and Post-Conflict

Toshihiro Nakamura – Policy Specialist UNDG

Ashok Nigam – Associate Director Country Office Business Operations and Funding Issues

UNDP Bureau for Crisis Prevention & Recovery (New York office)

Jan Harfst – Consultant on Area-Based Development

Christian Lotz – Peacebuilding Advisor UNDP

Jonathan Ng – Quality Assurance and Audit Advisor UNDP

Mia Seppo – Country Program Advisor UNDP

UNDP Multi-Donor Trust Fund Office

Henriette Keijzers – Deputy Executive Coordinator

Sana Zemri – Project Officer

UNICEF (NY)

Leslie Young – Fund Monitoring Specialist, Public-Sector Alliances & Resource Mobilization Office (PARMO)

UN Peacebuilding Support Office

Jonathan Andrews – FPB

Genevieve Boutin – Policy, Planning, and Evaluation Branch (PPE)

Patrice Chiwota – Financing for Peace Building Branch (FPB)

Calum Gardner – FPB

Julien Serre – FPB

Millennium Challenge Corporation

Darius F. Teter – Director MCC

World Bank

Marcelo Fabre – Sr. Operations Officer FCC Group

Faris Hadad-Zervos – Advisor FCC Group

Kelly Johnson – Operations Officer FCC Group

International Monetary Fund

Jan Kees Martijn – Deputy Division Chief PRGF Operations Division/Policy Development and Review Department

Michael Tharkur – Sr. Economist, Low-Income Countries Division/Strategy, Policy and Review Department

Annex E

Conclusions and proposed next steps: "Risk and Results Management in Development Cooperation: Towards a Common Approach"

Copenhagen 26 November 2010

On 25 and 26 November 2010, experts and policy makers from a wide range of member states and international development and humanitarian organisations met in Copenhagen to explore issues relating to the risks inherent in development cooperation, including both humanitarian, development and stabilisation interventions. The conference aimed to review different organisational perspectives on risk and risk management, to share learning from the experience of aid engagement in selected contexts, and to identify practical options for managing results and for improving financial, operational and political risk management.

The conference focused particularly on risk management in "transitional" contexts. The term "transition" captures the need for urgent and rapid support to lifesaving activities, while at the same time reflect the notion of countries transitioning out of conflict and/or instability towards sustainable development, greater national ownership and increased state capacity. These contexts often involve multiple overlapping policy agendas and principles for engagement, and require shared spaces between many different institutional actors.

A starting point for the discussion was the recognition that development cooperation is inherently political, and that risk is inherent in engaging in the contexts described above. Participants agreed on the overarching principle that the risks inherent in engagement in such contexts are largely outweighed by the risks of *not* engaging. The issue was not whether to engage but *how* to do so most effectively and in ways that minimise harm or involve acceptable levels of risk. In that sense, risk management is closely related to the achievement of results: attempting to achieve more ambitious strategic objectives is likely to entail higher degrees of risk.

Participants expressed a commitment to work towards a more coherent approach to risk management, noting that this might require more harmonized approaches to risk management within and across the different policy spheres. Taking note of the conclusions and recommendations of the forthcoming OECD INCAF Study on Aid Risks in Fragile and Transitional Contexts, participants agreed on the following key conclusions and recommended actions.

Key conclusions

- *Be willing to accept certain risks:* Risk management involves *taking* risks as well as avoiding or minimising them. It is about finding a balance of risk and opportunity, and the ability to take advantage of sometimes narrow windows of opportunity or transition points.
- … *and make sure to communicate the case for engagement and risks involved:* Greater honesty about risk and the political challenges of aid engagement is required in public communication by donor governments. Greater transparency is to be encouraged, recognising that there may be sensitivities around particular initiatives. It is essential that the case for engagement is clearly formulated and communicated, including the anticipated consequences of *not* engaging. The risk of non-engagement may often be much higher than the risk of active engagement.
- … *but make clear that accepting risks does not imply tolerance for risk outcomes:* Exposure to corruption and fiduciary risk is an inevitable part of engagement in fragile states – but that does not mean that it has to be tolerated, or cannot be managed.
- *Be context-specific:* Risk analysis and risk management has to be context-specific, starting with the contextual risks and in particular the risks faced by affected populations. It is this that justifies the cost and risks of engagement. Tools to manage contextual risks has to be further developed.
- *Manage risks at the country-level through appropriate engagement with a clear political mandate:* Critical to effective engagement with contextual risks is maintaining sufficient presence on the ground and engaging consistently over time. That engagement has to be *political* as well as through technical aid programmes: this cannot be reduced to an aid management agenda. Bilateral donor governments should stay politically engaged, and aid approaches require a clear political mandate.
- *Identify appropriate results:* Greater realism is required in the setting of targets and in the reporting of results. The timeframes within which

strategic objectives can be expected to be achieved in these contexts may run to decades, but it is important to be able to demonstrate interim results and establish milestones for progress. The high risk of failure to achieve objectives and the need for flexibility in relation to changing circumstances has to be recognised from the outset.

- … *and be realistic about the level of ownership required to achieve these:* It must be recognised that full implementation of the Paris principles takes time in these contexts, and may require a gradual approach. This in itself should not be an excuse either for non-engagement with national actors or for delaying implementation of critical aid programmes.
- *Adopt appropriate accountability standards:* The accountability standards that are applied in more stable development environments may not be appropriate to transition contexts. Accountability frameworks have to be realistic, tailored to the demands of high risk environments and designed to facilitate delivery in such contexts. The cost of controlling aid must be kept in proportion to the scale of the intervention.
- *Focus on prevention:* The best risk management approaches involve *preventive* action. This is partly a question of efficiency: the cost of preventing problems is much less than that of fixing them when they arise. In particular, more needs to be done to articulate the case for disaster risk reduction and conflict prevention.
- *Explore options for differentiated approaches to risk management:* Different actors bring their own mandates and comparative advantages to these contexts. The diversity of approaches can be a strength: rather than search for a single system of risk management, aid actors should seek complementarity between their respective approaches. This allows for greater flexibility, including different modes of engagement with national and local authorities.
- … *and for transferring/ pooling risks:* Related to the above, the benefits and limitations of risk transfer and risk pooling must be recognized. Those to whom risk is transferred have to be enabled to manage the risk in a way that does not compromise their effectiveness.

Towards a new approach

Establishing a more appropriate risk culture within and between organisations is essential to progress, in particular in contexts that require shared space between humanitarian, stabilisation and development actors. A new approach to risk and results management would require:

- *Agreement on terms and concepts:* Jointly defining terms and categories related to risk, including distinguishing risk outcomes and risk factors, as a basis for a more coherent approach across the different policy spheres. The three categories of risk proposed in the forthcoming INCAF Risk Study[1] provides a useful starting point in this respect;
- *Information sharing:* Pooling information and sharing learning between the different actors on the most effective and appropriate risk management approaches is an important step towards more coherent, harmonised approaches;
- *Differentiated risk management approaches:* Donors should increase flexibility in their risk management approaches, including by developing differentiated risk management models that are adaptable to individual contexts;
- *Multilateral reforms:* Donors should also support efforts to enable multi-lateral actors, including the UN and the World Bank, to amend their operating rules and procedures in order to adopt financial risk mitigation measures that better support innovative programme approaches and, ultimately, successful humanitarian and development outcomes;
- *Effective communication:* More effective public information strategies highlighting the risks inherent in these contexts and in appropriate responses, may assist in managing expectations of results and support greater flexibility for donors;
- *… based on joint messaging about risks:* As part of this, more joint work at the global and country level to develop a narrative around the need to engage and accept certain risks. The case for engagement needs to be clearly documented, as should the consequences and costs of *not* engaging;
- *Effective coordination:* More effective coordination at global and field levels between the different policy spheres would facilitate better understanding of the differences in current approaches, acknowledge potential tensions, and support progress towards greater coherence;
- *Shared understanding of risks through joint risk assessments:* For operational agencies, a capacity for risk assessment, pooling of information and analysis, as well as a capacity to facilitate common risk management strategies where appropriate, is required at global and field levels. A shared understanding of risk between different actors at the country level is essential to more coherent risk management.

Opportunities for follow-up action

Delivering on the above will require continued and coordinated efforts over the coming period at both policy and operational levels. More specifically, the following processes and actions should be used as vehicles:

- The conclusions outlined here should be tabled at the OECD International Network on Conflict and Fragility, the Development Assistance Committee, and the International Dialogue on Peacebuilding and Statebuilding for further elaboration and translation into concrete actions;
- The results of these further deliberations should feed into the Fourth High-Level Forum on Aid Effectiveness in Korea in 2011 for endorsement;
- The conclusions and recommendations from this conference should also be included in subsequent guidance on engagement in fragile states, such as the forthcoming INCAF Guidance on Transition Financing;
- Further consultation is needed with existing humanitarian and development coordination mechanisms such as IASC, ECHA, UNDG at the global level, and the UN Country Team or Humanitarian Country Team at the field level. The conclusions from this conference should also be raised with the boards of relevant international organisations for deliberation;
- Further collaboration is needed on information and evidence sharing and on development of appropriate tools for shared risk analysis and assessment, particularly at the country and regional level. At the global level, better frameworks are needed for assessing risk to enable more coherent approaches to risk management. Opportunities for piloting new risk management approaches in the field will also be explored.

Note

1. See OECD DAC INCAF, "Aid Risks in Fragile and Transitional Contexts: Key Messages from the forthcoming publication Aid Risks in Fragile and Transitional Contexts".

Annex F

Terms of reference: Framing Paper on Risks and Risk Management Strategies Associated with the Delivery of International Aid to Fragile and Conflict-Affected Countries

I. Background

The New DAC International Network on Conflict and Fragility (INCAF) has decided to do more detailed work to explore different financing issues during the transition from humanitarian to development activities, as part of its 2009-10 Programme of Work and Budget (PWB).[1] The overall objective of this work is to develop specific recommendations that can enable earlier and faster release of funds during the transition period through allowing for higher tolerance of risk and facilitate more effective implementation. The efforts will be spearheaded by the Financing and Aid Architecture Task Team and the outcomes will feed into the INCAF's intermediate output 1.2, "Progress report on implementing the 2007 High Level Meeting Policy Commitment to improved development effectiveness in situations of conflict and fragility including tracking resource flows."

Recent experiences show the crucial importance of providing and delivering adequate financing to situations of conflict and fragility, to ensure that life-saving activities are continued while at the same time providing targeted peace dividends and livelihood support, and to start building the foundations for sustainable recovery, peace building and state capacity. However, donors have found it difficult to provide such effective and targeted support to countries recovering from conflict for a variety of reasons, including:

- The lack of clarity on how to prioritise between short and medium term activities;
- The existence of different, and often segmented, aid systems and paradigms;

- The different priorities, funding cycles, procurement rules, targets and indicators guiding engagement;
- The particularly difficult coordination and cooperation challenges between different operational and policy communities during the transition period, which would require a shared space between humanitarian and development actors;
- The proliferation and fragmentation of mechanisms at country and headquarters levels in response to urgent priorities and the limited donor field presence;
- The lack of effective procurement procedures that are tailored to the specific transition challenges;
- The lack of consensus on how to ensure that funds can flow freely between different instruments, based on the comparative advantage of each, and how to properly manage the transition points and enable financing of key activities;
- The political bias of aid with regards to who benefits and who implements (*e.g.* influencing power sharing arrangements and the political economy of transition governments), and;
- The lack of neutral partner organisations capable of handling funding inflows.

A particular constraint to the delivery of international assistance is that transitions are by definition risky environments, where the needs are high, the context is complex and capacity to deliver is limited. Crises are often high profile and politically charged both for the country in question as well as the international community. Aid in these situations is easily politicised, and can be powerful incentives as well as subject to conflict dynamics. The risks associated with delivery of aid are thus high, and donors often adopt complicated and process-heavy risk management strategies to compensate for these risks that generate an operational environment that is not well configured to deliver adequate financing to situations of conflict and fragility.

An important part of the Task Team's efforts will thus be to better understand the political economy of aid in situations of conflict and fragility and to uncover the specific risks and risk management strategies that can be applied to ensure delivery of sufficient, flexible, timely and effective aid during the transition period. These efforts will in particular need to take account of and recognise existing principles for engagement and the importance of maintaining minimum but sufficient levels of accountability. The following outlines the terms of reference for a study that explore these issues.

II. Aim and objectives

The overall aim of the study is to develop practical guidance that can help the donor community develop strategies for better identifying, assessing, mitigating and managing risks associated with early release and flexible use of development funds during the transition period. More specifically, the study will produce a framing paper that will inform and help INCAF members understand the following issues:

- Analyse major trends in international engagement in situations of conflict and fragility and how these may influence the relative value of and risks from using different aid delivery tools;
- Identify how donors and agencies are currently approaching and addressing risks, including through specific procedures, timelines involved etc;
- Provide an overview of the political economy of aid during the transition period;
- Identify the main risks and opportunities posed by the transition and by the international community's response, highlighting those risks that cannot realistically be reduced and those risks that are under the control of the development and humanitarian communities;
- Develop a matrix that spells out the various risks, shows how they impact on each other, notes how they are influenced by the different transition contexts (*i.e.* clear victory in a conflict vs. power sharing arrangements), and pinpoints the political implications for donors of taking on the risk, along with specific implications of inaction;
- Make the case for why it is necessary for the donor community to take on more risk in fragile and conflict-affected situations to capitalise on opportunities that might arise and maximise the effectiveness and efficiency of assistance; and
- Provide specific recommendations on what risks can be addressed and suggest specific risk mitigation strategies and measures and the sort of financing and procurement models that could be applied to balance risks and the need for minimum accountability.

The objectives of the framing paper are to promote greater consensus and clarity inside and outside the DAC on how development funds can be released more rapidly and with greater flexibility, and provide specific recommendations that the Task Team can consider when producing guidance on transition financing. In doing this, a key challenge for the consultants will be to make a balanced assessment of the multiple risks involved in

the international community's financial response to transition situations. Decisions will need to be made regarding which risks are unavoidable and what risk threshold might be necessary if the international community is to effectively support a transition with the significant potential improvements and opportunities for development it will usually present. For this to happen, a more detailed understanding of risks, current approaches taken by donors and possible future approaches and risk management strategies will be needed.

III. Issues to be addressed

In responding to these TORs, the consultants will need to address the following issues:

1. What is the political economy of aid during the transition period?

1. International assistance to countries transitioning out of conflict does not take place in a vacuum, but needs to be positioned within the context of the complex local, regional and global environment these fragile and conflict effected countries face. Countries in transition are not only dealing with conflict, armed violence and poverty but are also contending with externalities such as climate change, environmental degradation, international crime, population migration etc. that may influence stability and prospects for development as well as creating significant negative spill-over effects on neighbouring countries and the international community when transition fails. The international system is not yet well equipped to deal with these larger regional and global issues and their local impacts, and humanitarian and development actors represent just one, relatively small player when it comes to addressing these themes. The paper should thus identify, recognise and take account of the risks to successful transitions posed by these global elements and the opportunities that reducing regional and international negative spill-over effects present. At the same time, it should identify and focus its attention on those risks which are inherent in development and humanitarian aid modalities, and in the current financing and procurement models, and which are under the control of development and humanitarian actors.

2. The paper should build on and further a broad understanding of the political economy of transition situations. A post-conflict situation is often characterised by very weak political institutions, a charged political environment and an economic system in crisis, which heightens the risk of slipping back into conflict. Therefore, a clear understanding of the characteristics of each of these three aspects

and the dynamics between them is necessary to identify the main risks to a smooth emergence from crisis. The discussion should address the short and long-term political, social and macro-economic factors which impact on stabilisation. The analysis should be broad enough to include the most common elements found in transition situations such as international crime, illegal trade in natural resources, migration, gender aspects and refugee flows. It should furthermore look at how regional settings and dynamics impact the political risks of aid during the transition period as well as the impact of destabilizing global issues mentioned above, and how all of this relates to risk and aid modalities.

3. The paper should also consider the political economy of the international community's engagement in transition situations. This would include identifying the principle objectives of the donor community's involvement in these situations; the tools and instruments available and donor policies and procedures for identifying needs and allocating funds; the main patterns and dilemmas of aid provision in transition situations; key issues such as funding gaps, difficulties in dove-tailing humanitarian and development programmes; confusion created by different objectives and principles (short term vs. long term, delivering services vs. national ownership) etc. Furthermore, it should explore the rationale behind donor countries' engagement in transition situations, identifying the main factors which influence the degree to which they get involved (the amount of financing and political capital expended). Together, these aspects will shed light on the extent of the risk donors are prepared to take to achieve their goals in transition situations.

2. What are the different risks associated with delivery of aid during the transition period?

1. The consultants should attempt to identify the range of risks (known and unknown) that might be encountered during the transition period, to identify specific options for addressing and managing these. Risks may cause negative departures from desired transition scenarios and trajectories. More knowledge of risks and a better understanding of the risk factors may allow donors to anticipate and account for risks, and on that basis mitigate risks better and be able to take more risks. Nonetheless, as the effects of risks are rarely certain, factors such as poor policies and procedures that will almost certainly cause problems will not be covered by the study. Conversely, even the best planned and implemented development activities will always entail risks and uncertainties that need to be considered systematically.

2. In an effort to order the discussion, and for the purpose of this paper, risks have been grouped together under three headings; (i) political risks; (ii) financing risks; and (iii) technical risks.

3. **Political risks** should be broken into risks for the country in transition and political risk for the donor:

    - An analysis of the **political risk to the country in transition** needs to rest on the understanding that aid rarely remains neutral in a post-conflict transition environment. Rather, association with or exclusion from projects and funding decisions influence local power politics and often creates winners and losers. Different aid modalities can lend support to different sides of or entities within a conflict; project approaches which bypass local authorities can serve to undermine governments' authority in the eyes of the population, whilst channelling funds through governments may prop up one side of a political divide. These dynamics can affect how local partners interact with the international community and their willingness to cooperate. Similarly, the patterns and perceptions of aid flows to states within a region can also have an impact on regional dynamics which may in turn affect stability at a regional, national and local level.

    - For the **donor** there are a set of reputational risks that influence levels and types of engagement in a transition situation. The donor will consider its ability to deliver assistance and to achieve results in a complex transition environment, the security risk to staff involved in delivering assistance, the security and reputational risk resulting from doing nothing. These risks (the list is by no means comprehensive) influence the donor's decision to engage in the transition, how much to invest (politically and financially) and what aid instruments to use. The extent to which a donor is prepared to broker the multiple risks and engage in transitions is also influenced by domestic public opinion and geo-political considerations. The study should consider what contributes and effects the perception of risk, including issues such as access to and availability of information and the presence of other donors.

    - There are a further set of issues around donors acting as a group or individually. A coordinated and coherent response by the international community during transitions is particularly difficult due to the urgency of a transition context, the rapidly changing situation the lack of clear structures, weak national leadership, and the multiple actors and stakeholders involved that tend to create a high level of volatility and uncertainty. Lack of coherent political messages and uncoordinated aid

risks confusing local actors at best, at worst contributes to destabilising an already fragile situation.

4. Looking at **financing risks** would involve exploring and addressing questions around levels, patterns and sustainability of financing.

   - There are a number of risks associated with the interplay between issues around financing gaps, absorption capacity, scaling up and front loading. Different approaches to financing levels will expose different risks. Bearing in mind the need for quick impact post emergency and the importance of reducing the lag time in implementing projects, donors need to start planning for the transition phase during the crisis itself and be prepared to take indicative decisions on financial engagement at an early stage when risks are even higher.

   - Financing risks should be addressed through a lens of realism, noting what is aspirational but focussing on what is achievable.

   - There are important fiduciary risks associated with aid during the transition period. In particular, the lack of functioning accountability mechanisms and capacity combined with an increased inflow of external assistance risk generating corruption at all levels. Financing during this period will thus need to accept a higher level of risk due to the lack of effective in-country budgeting and accountability mechanisms, in particular in cases where aid is made available before a political settlement has been established.

   - Nascent accountability, financial management and procurement capacity will also be placed under increasing stress during the transition period due to the highly political nature of aid (as discussed above) and because external financing would normally represent a higher proportion of the overall resource envelop during this period.

   - Donors need to carefully consider issues related to longer term macro-stability and fiscal planning. There are specific financing risks associated with the dilemma of matching immediate financing needs while at the same time ensuring that aid levels in the short term do not exacerbate the risk of creating unsustainable fiscal structures in the long term.

   - Similarly, the issue of debt relief needs careful consideration during the transition period. Debt relief plays a critical role in helping states achieve debt sustainability and stabilise the macro-economic situation. It is also often used as a primary carrot to achieve a political settlement. Nonetheless, debt relief can have

adverse effects on the macro economy of a country if the additional fiscal space created undermines broader macroeconomic stability and public finance management objectives, and donors thus need to carefully consider the various financing flows in a given country context.

5. The study should also look at different **technical risks** associated with different aid instruments have different risks associated with them.

   - Fragile and conflict environments are often characterized by a lack of technical implementation capacity that increases the risk of problems in the delivery of aid through local systems and partners. This risk may to some extent be mitigated through direct delivery through international agencies and NGOs, but this modality will have to be balanced against the need to ensure that long-term statebuilding and sustainability objectives are met.

   - In addition, there is also often a lack of fundamental data and information that are normally considered necessary for proper needs assessment, planning, decision making and monitoring of aid activities. This includes the lack of economic and social statistics, including statistics that is sensitive to gender and ethnic/regional criteria that may be the basis for exclusion and drivers of conflict. In addition, there is often a lack of effective media and accurate and balanced reporting of events.

   - Project approaches reduce the fiduciary risk related to working with governments, however, they have increased risks relating to a lack of sustainability and ownership, but in the case of budget support the benefits and risks are reversed. It would thus seem important to delve into the detail on each of the pros and cons posed by using the various aid instruments outlined by the mapping study of the transition period.

   - Technical risks can also be found when looking at disbursement and capacity to deliver. For instance, what are the specific risks associated with international and local procurement systems, and how can these be improved to better reflect capacity, implementation and accountability needs during the transition period.

   - Finally, technical risks might be associated with the sustainability of aid interventions (in particular development investments). In volatile situations, and given the urgency for implementation, there might not be sufficient information or capacity available to make qualified judgements for ensuring sustainability of activities.

While quick and visible results are needed to consolidate peace in the short-term, the impact of these investments could be reversed if they are not perceived to result in sustainable improvements in service delivery.

3. What are options for mitigating different types of risks?

1. Once the various risks are clearly mapped out, the study should explore options for how to address, mitigate, and to some extent accept the risks involved (noting that risks are higher in transitions than in regular development contexts, but that positive opportunities for development are also much greater if fragility and conflict can be overcome). The study should suggest a basic framework for cost-benefit analysis that would indicate the implications of both inaction and accepting higher risk thresholds. This cost-benefit analysis framework should build on either existing or new quantitative analysis as far as possible. The consultants should also take care to address moral hazards around the various choices and trade-offs. Furthermore, the paper should explore whether and how the risks identified can be mitigated, looking at the full range of options.
2. The consultants would also be expected to address the question of whether the international community should to be prepared to take on a higher risk threshold in transition situations, arguing the case for why this is necessary and appropriate, while bearing in mind the need for a minimum level of accountability, and giving recommendations on how this could best be achieved. This discussion would draw on the political economy section, identifying what is necessary to achieve the various goals. It should then evaluate the balance between the risks encountered through action and engagement at a sufficient level to achieve these goals versus the risks of doing nothing, or not enough, building on the cost-benefit analysis framework.

IV. Approach and methodology

The framing paper will address a very wide agenda and will need to aim for breadth rather than depth to address the various risks outlined above. It will need to draw on a wide range of both historical and contemporary sources and take a multidisciplinary approach as well as examine policy sources. In order to ensure a sufficiently broad approach to the topic, the consultant team will need a multinational character.

The study would be initiated by a desk review looking at work done by the DAC as well as by other partners to explore issues related to transition

financing. It would then move on to a more detailed analysis of the key risks involved, which would involve in-depth interviews with key donor representatives and external experts, and possibly through specific field work to highlight good practices for risk mitigation strategies.

More specifically, the study would be based on:

- The findings of the two mapping studies that have been prepared on (i) instruments and tools available during the transition period and (ii) donor policies and procedures;
- A literature review of recent academic and policy work;
- Interviews with DAC representatives and other stakeholders working on financing issues in the transition period, including with humanitarian and private sector actors;
- A review of relevant published and grey literature produced by DAC members and others;
- Interviews with national and regional policy makers and other relevant actors such as think tanks (from both fragile and "stabilised" post-conflict countries);
- Field work to draw specific lessons on risk mitigation strategies in situations of conflict and fragility.

Given the large effort involved, and the need to bring in expertise in humanitarian, development, economic and political analysis from both HQ and the field, a Consultant Consortium might be the preferred option.

Given the political dimensions of the study, several steering group meetings would be foreseen to enable members to follow and guide the process, to engage in and handle any emerging sensitivities on an ongoing basis, and to advise the consultants on an ongoing basis. Furthermore, an expert advisory panel will be contracted to support the steering group and advise on emerging findings. The final product will be presented during a workshop with donors and others, aimed at highlighting the practical and political implications of the findings for a wider audience outside INCAF.

Following completion of the framing paper, the work might be complemented by a more detailed cost-benefit analysis of certain types of risks or specific case studies. The final work will be presented at a workshop with donors mid 2010, following which it will feed into the development of specific guidance by the Financing and Aid Architecture Task Team.

V. Outputs

The first output will be an inception report and a literature review (maximum 15 pages) outlining the proposed approach, focus and methodology that the consultants will adopt for the main study. In particular, the inception report should include a detailed outline of what risks will be addressed during the study and why these specific risks were chosen. Furthermore, it should set out a proposal for possible country and/or case studies that should be covered in the framing paper, as well as the criteria that should be applied when deciding on the sample (based on the elaborated understanding of the risks that will be explored). Finally, it should propose a more specific set of questions that should be explored in each case study, which will serve as a basis for the Steering Group discussion on the purpose and content of these cases.

A first draft of the framing paper should be delivered by end February 2010 (maximum 40 pages). This should analyse major trends in international engagement in situations of conflict and fragility, provide an overview of the political economy of aid during the transition period and identify the main risks and opportunities posed by the transition and by the international community's response and suggest ways in which these can be mediated. The paper will contain an executive summary of not more than 3 pages; a full bibliography; a list of interviewees; and any annexes the authors feel are necessary. This should be delivered by 15 February 2010.

Following presentation and discussion of the framing paper in an experts meeting, the consultants will produce a second iteration of the framing paper (maximum 60 pages plus annexes). This paper should be delivered by 30 April 2010 for a final round of comments from the Task Team.

The final paper should be delivered by June 2010, and should include an executive summary; a full bibliography; a list of interviewees; and annexes covering each of the case studies as well as any other annexes the authors feel are necessary. It should also include a matrix that spells out the various risks, shows how they impact on each other, notes how they are influenced by the different transition contexts (*i.e.* clear victory in a conflict vs. power sharing arrangements), and pinpoints the political implications for donors of taking on the risk, along with implications of inaction. In addition, a shorter summary paper should be prepared, highlighting policy and operational recommendations for how donors can manage and mitigate specific risks.

Note

1. During its first meeting on 15-16 January 2009, the Task Team agreed that the broader term "transition financing" will be used to cover the wider set of issues that might be experienced during the transition from humanitarian crisis towards longer-term development. As such, the term might include activities that are currently labelled early recovery, recovery, transitional etc., recognising that this period can start before there is peace and carry on into the post conflict period.

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