

MANAGING RISKS

85. In Sri Lanka, where the operating environment is fraught with conflict and tensions, the risks to the Bank's engagement are considerable. There are two over-riding sources of risk to the Bank's effectiveness: a dramatic escalation in the conflict and a serious macroeconomic crisis. The Bank faces considerable reputational risks—for example, of being perceived as being biased against any one side in the ethnic conflict. Finally, the Bank's fiduciary risks are also non-negligible. While the Bank's ability to fully mitigate some of these risks is ultimately limited, it must be recognized that there are substantial potential benefits to the Bank's engagement in terms of working towards resolution of the long-running conflict in Sri Lanka. In this sense, there may also be significant development and reputational risks to not being materially engaged.

A DEVELOPMENT EFFECTIVENESS RISKS

86. A further escalation in the armed conflict remains the over-riding risk to the effectiveness of the Bank's work. A sharp escalation in the armed conflict would have an immediate impact on the Bank's ongoing operations in the North and East, either through direct security and logistics constraints or further pressures on politicization of projects. An escalation could also further undermine the stability of the macro-fiscal situation in the country and divert the attention of policy makers away from development issues. The Bank would seek to respond flexibly to the evolving situation but could ultimately be forced to hold back disbursements of certain projects if the security situation deteriorates to the extent that development effectiveness is undermined.


87. Derailment of the macroeconomic situation is another key risk. This risk can only be mitigated by decisive action on the part of the Government. The Bank monitors the evolving macro-situation closely, including through frequent meetings with the Central Bank and sharing its analysis and concerns with key counterparts. At the same time, the Bank will strengthen attempts to nurture the public debate on macroeconomic policy formulation to build consensus around a stability-oriented policy stance.



B THE BANK'S REPUTATIONAL RISKS

88. The conflict is a key source of reputational risk to the Bank. Reputational risks can arise, in particular, if the Bank is perceived—even inadvertently—to be disproportionately favoring one ethnic group over another and thereby contributing to inter-ethnic tensions. In implementing the CAS, the Bank will take several measures to mitigate these risks. The Bank is committed to an objective approach, based on sound analysis of where the needs are greatest, and strict technical criteria for project selection. One measure to

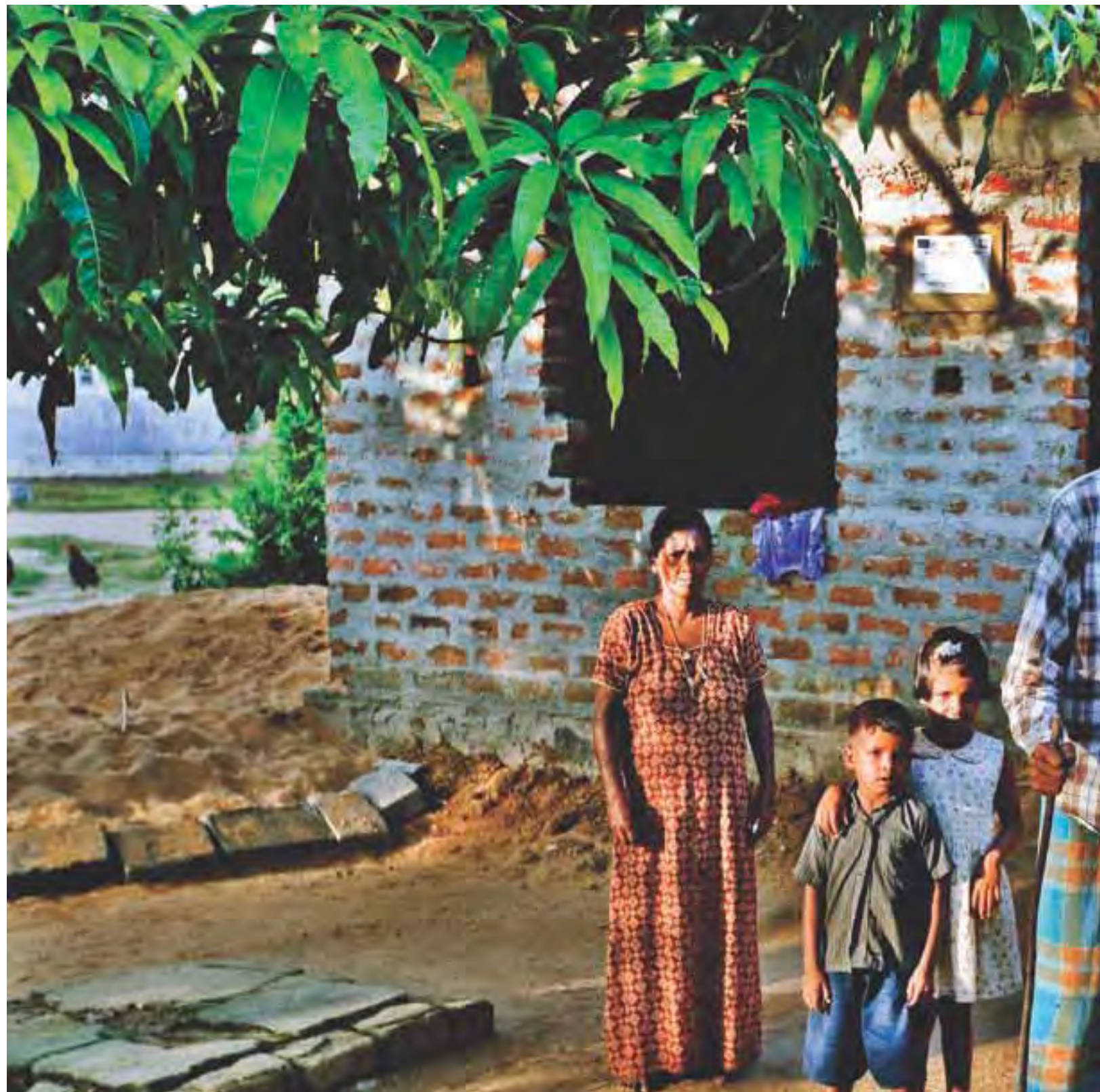
safeguard the Bank against allegations of disfavoring the North and East would be that the Bank would not approve reallocation of already committed resources from the North and East to other parts of the country. This would mean that if funds allocated for the North and the East are not fully utilized, the funding envelope for the country as a whole would effectively shrink. In addition, as described earlier, all ongoing and future lending activities of the Bank would be subjected to a 'conflict filter'. To effectively implement the conflict filter and enhance the conflict-sensitivity of the Bank's program, the country team would proactively seek support and guidance from relevant Bank departments, in particular the Fragile and Conflict-Affected Countries group and the Social Development Department. It is also expected that an externally funded full-time conflict advisor would be added to the Country Office staff. Moreover, the Bank is collaborating with other development partners, including through the Donor Peace Support Group, to develop and improve conflict-sensitive approaches to development assistance in Sri Lanka.



The vast majority of Sri Lankans live in rural villages and are small scale farmers.

89. The evolving governance situation also exposes the Bank to reputational risks. These risks may materialize if the Bank is associated in its projects with individuals/institutions who/which are controversial or seen as corrupt. A perceived failure to address possible corrupt practices in Bank-financed projects would add to these reputational risks. The Bank expects that its stepped-up focus on the governance and anti-corruption agenda, better efforts to reach out to other stakeholders in this area, and enhanced attempts at managing fiduciary risks (see below) will go quite some way towards mitigating these risks.

MANAGING RISKS



It is common to see elderly parents living with their children and cared for by the children in the conflict displaced families in the North and the East. 62 year old Paramakutty Nadarajah is looked after by daughter Nadarajah Siridevi. North East Housing Project Puthukkudieruppu, Arayampathy DS Division, Batticaloa.



C FIDUCIARY RISKS TO BANK-FINANCED ACTIVITIES

90. Fiduciary risks in Sri Lanka are considered substantial⁹. This rating is based mainly on three issues: (i) the volatile situation in the North and East which impedes supervision and increases the risk of interference in project implementation by various outside stakeholders, including militant groups; (ii) examples of political interference in decision-making and appointment of key project management staff which undermine the effectiveness of project management and coordination; and (iii) the disbanding of the National Procurement Agency (NPA) which, at least temporarily, has resulted in increased uncertainties about the strength of the institutional set-up for public procurement.

91. There are weaknesses in both financial management and public procurement. In financial management, key weaknesses are capacity constraints in public external and internal audits; poor compliance and weak enforcement mechanisms of financial regulations; an input focused culture; weaknesses in a fixed asset and inventory management framework; and inadequate institutional arrangements to professionalize public sector accountants and provide them with continuous professional development. In public procurement, a great deal of work has taken place over the past several years to develop the regulatory and organizational foundation for effective public contracting. Under the direction of the NPA, modern regulations have been drafted, standard bidding documents have been developed, procurement units have been established in major spending agencies, officials have been trained, and the basic structure for reporting and monitoring on procurement

⁹ This is the second-highest risk rating on the Bank's four-point scale (Low, Modest, Substantial, High).



has been initiated. The challenges that face the procurement system primarily relate to effective implementation of procurement rules. Procurement procedures continue to be irregularly applied and cases of post-contract manipulation, payment stoppages and inadequate post-award supervision remain significant issues. A robust performance monitoring system does not yet exist and oversight is further weakened by the lack of an effective grievance-redressal mechanism. The recent decision to disband the NPA and shift its functions to a unit in the Ministry of Finance has raised concerns about the Government's commitment to ensuring full implementation of the existing procurement regulations, although the Government has assured that it remains fully committed to good public

procurement. The ultimate implication of these changes for public procurement will not be known anytime soon and the Bank will liaise with the Government in monitoring the situation closely.

92. Going forward, the Bank will strengthen its attention to fiduciary risks in project design and project supervision, building, inter alia, on the lessons from the India Detailed Implementation Review (DIR).

- In terms of project design, fiduciary staff will be engaged on project teams to carry out preliminary, project-specific risk assessments already at the PCN stage. Sector fiduciary risk assessments would help to identify cross-cutting issues, opportunities for

corruption, and potential incentives and disincentives for corruption. Where warranted, anti-corruption Quality Enhancement Reviews (QERs) would be held with the objective of: (i) brainstorming for and documenting potential entry points for corrupt practices within overall sectors and specific projects; (ii) assessing the likelihood of each corrupt activity occurring; (iii) estimating the impact on the project outcomes should the corruption activity occur; and (iv) identifying a set of tailored risk mitigation measures to combat the corrupt activity. Project-specific anti-corruption strategies would be developed as necessary. Project design would also place more emphasis on: (i) enhancing transparency and social accountability by designing better communication channels with beneficiaries and other stakeholders, including civil society; (ii) enhancing the disclosure of accurate, timely, and clear project information across a wide array of public fora and media; and (iii) developing policies to promote detailed value-for-money reviews in the use of project and government resources. The Bank will also focus more strongly on establishing effective multi-language complaint mechanisms, mobilizing third party and community monitoring of procurement transactions and outcomes, and using information technology in procurement in order to enhance transparency.

- In terms of supervision, the fiduciary teams employ a risk-based approach. Currently, 5 of the 14 ongoing projects are considered fiduciary 'high risk' for a variety of reasons, including comparatively weak implementation capacity, perceived high risk of political interference in project implementation,

¹⁰ The five projects are the Tsunami Housing Project, Community Livelihoods in Conflict Affected Areas Project, HIV/AIDS Prevention Project, Health Sector SWAP, and E-Lanka (the latter is only considered high risk with respect to procurement).



Sumith Kumari Secretary village committee, Heeloya, Watagala.

or high exposure in conflict-affected areas . Additional implementation and fiduciary safeguards are being put in place for these projects. In the Community Livelihood in Conflict Affected Areas project, which has recently been restructured, the Bank intends to strengthen third party monitoring of project implementation and review, on a sample basis, financial management and procurement transactions in target villages. The risk-based approach allows the Bank to tailor supervision more closely to the risks associated with different types of projects—for example, in SWAPs that are particularly exposed to weaknesses in country systems or community driven projects that face

The indigenous people break out in a dance at the Dambana Rural Hospital grounds.



risks from low fiduciary capacity in communities. Supervision would be focused on not only ensuring compliance with agreed covenants and procedures but ensuring that: (i) funds have reached the intended beneficiaries; (ii) physical progress is aligned with payments; and (iii) suppliers are paid on time and against deliverables. Finally, increased use of joint financial management, procurement, technical supervision, and post reviews-including post-contract asset auditing, would be employed.

93. Project implementation and supervision in the conflict-affected areas pose particular challenges due to limited access. In particular, the LTTE-held districts of Kilinochchi and Mullaitivu in the North are currently off-limits to Bank staff, as are the areas on the frontlines in the Mannar,

Vavunia and Jaffna districts. To supervise activities in these areas, the Bank relies on inputs from local authorities, consultants and civil society organizations. For example, for our Education SWAP which provides funding for teacher skills development, text books, some school equipment, etc., in the entire country (including the Kilinochchi and Mullaitivu districts), a special unit in the Finance Commission has been established and charged with inter alia supervision of implementation in these districts. In other cases (for example, the North East Housing Reconstruction Project), it has been decided to temporarily suspend disbursements, in part because of difficulties in supervision and in part because of difficulties in ensuring a steady flow of necessary materials and equipment.