

PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: 84219

Operation Name	CATASTROPHE DEFERRED DRAWDOWN OPTION (DPL with DDO)
Region	SOUTH ASIA
Country	Sri Lanka
Sector	Public administration- Financial Sector (50%); General finance sector (50%)
Operation ID	P147454
Lending Instrument	Development Policy Lending
Borrower(s)	MINISTRY OF FINANCE AND PLANNING
Implementing Agency	Ministry of Finance and Planning
Date PID Prepared	January 21, 2014
Estimated Date of Appraisal	February 7, 2014
Estimated Date of Board Approval	March 27, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Sri Lanka is highly vulnerable to natural hazards. This was brought into sharp focus as a result of the Indian Ocean tsunami in 2004, which killed over 35,000 people in the country. Despite the enormity of this event, it is more routine flooding and drought that presents the most significant natural hazard threat to growth and development of Sri Lanka in the long term. This is particularly true for northern and eastern provinces, but most of the country suffers significant exposure to multiple hazards. During the period 2000-10, floods cumulatively affected more than 8.5 million people, while droughts have affected more than 5 million¹. In addition, landslides and high winds frequently destroy or damage thousands of houses every year. Though less frequent, cyclones have significant impacts. A cyclone in 1978 devastated the low-lying district of Batticaloa, killing more than 1000 people and displacing nearly one million. More recently, in 2000 a cyclone hit Trincomalee district and damaged or destroyed 83,000 houses in the country.

With the intensification and concentration of economic activity in vulnerable cities, the fiscal and economic impacts of disaster are likely to be high, and growing. Sri Lanka's Ministry of Disaster Management (MDM) estimates annual fiscal loss from disasters to be in excess of US\$50 million². In some years, the fiscal loss is much greater. For example, the floods of December 2010 to February 2011 resulted in estimated direct damages of more than US\$600 million.³ Indirect losses to the economy are unknown. While, the country experienced flood events in 2003, 2006, 2008, 2010, 2011 and 2012, the damages and losses have not been measured. Total damage from the 2004 tsunami was estimated to be around US \$1 billion and the estimated

¹ Sri Lanka Disaster Information System

² Ministry of Disaster Management

³ National Planning Department

financial needs - including immediate relief - were estimated to be twice as much. In spite of the large amount of aid, the sheer scale of the event exacerbated pre-existing economic instability, including a dip in Gross Domestic Product (GDP) in the first quarter of 2005.⁴

This operation is part of a broader strategy to help the GoSL shift to a more comprehensive, cross-government approach to the management of disaster risks. The Climate Resilience Program described in Annex 3 sets out an ambitious new wave of investment to identify and reduce climate-related hazard risks. The Climate Resilience Program comprises three core elements including i) Improving Climate Resilience Project, US\$110 million, aimed at developing basin investment plans and reducing physical risk; and ii) this CAT-DDO aimed at increasing fiscal resilience to disaster

II. Operation Objectives

The development objective of the proposed operation is to enhance the capacity of the GoSL to be more resilient to the impacts of natural disasters. This will be achieved by providing immediate liquidity to the GoSL in the event of a disaster within a policy framework designed to improve the overall capacity of the GoSL to implement its DRM program.

III. Rationale for Bank Involvement

The Development Policy Loan with a Catastrophe Deferred Drawdown Option (DPL with a CAT-DDO) is a relatively new financial product, which was approved by the Bank's Board of Directors on March 5, 2008. The DPL with a CAT-DDO can help meet Sri Lanka's need for immediate, liquid assets in the aftermath of a catastrophic disaster. The DPL with a CAT-DDO is a flexible and prompt financial tool to address risks to which the country is prone. It will enable the GoSL to focus on emergency response measures in the aftermath of a disaster rather than spend valuable time and resources trying to raise funds. The Board has approved a number of DPLs with a CAT-DDO, including in The Philippines, Costa Rica, Colombia, El Salvador, Guatemala, Panama and Peru.

There are three prior actions for this program that will improve the GoSL's ability to manage disaster and climate risks. The first is the adoption by Cabinet of National DRM Policy, as required under the framework of Sri Lanka Disaster Management Act, No. 13 of 2005. The second prior action, adoption by Cabinet of the Disaster Management Plan, will provide a roadmap for relevant stakeholders to increase physical resilience to disaster. A third prior action, Cabinet adoption of a national spatial data infrastructure will enable data sharing throughout government, which will improve understanding of specific disaster risks across sectors. As of January 21, all prior actions have been achieved, and the GoSL is demonstrating important progress in laying the structural and institutional foundations for sustained resilience to natural hazards.

Based on these prior actions, the proposed operation seeks to support the following policy areas:

⁴Dushni Weerakoon, Sisira Jayasuriya, Nisha Arunatilake, Paul Steele, [Economic Challenges of Post-Tsunami Reconstruction in Sri-Lanka](#), ADB Institute Discussion Paper No. 75, August 2007

- Policy Area 1 – Improved institutional mechanism for disaster risk management and financial protection
- Policy Area 2 – Increased capacity to ensure climate resilient development
- Policy Area 3 – Improved understanding of disaster risk

The macroeconomic outlook is also conducive to the Bank’s support to Sri Lanka. Growth is expected to remain buoyant. The fiscal balance and debt situation is expected to continue to improve, assuming continued efforts to enhance revenues, reign in expenditures and strengthen debt management. There is considerable room for revenue growth, given that current levels (about 13 percent of GDP in 2012) are low by international standards and compared to levels achieved in the 1980s (about 23 percent of GDP). Important reforms were enacted in 2011, simplifying the tax regime and broadening the base, in an effort to increase revenues. Continued efforts to increase efficiency of public spending, including improving value-for-money from public procurement and management reforms, will be essential.

IV. Tentative Financing

Source:		(\$m.)
Borrower		0
International Bank for Reconstruction and Development		102
Borrower/Recipient		
IBRD		
Others (specify)		
	Total	102

V. Institutional and Implementation Arrangements

While the Ministry of Finance and Planning (MoFP) is the main counterpart of the Bank for this DPL with a CAT-DDO and direct beneficiary, the implementation of the program is a shared responsibility with the MDM. The MDM, as the coordinating agency for the GoSL, holds many of the key responsibilities set out in the DM Policy and NDMP. The policy priorities reflect a number of the key actions required as viewed by MDM in this context, with the added benefit of having the oversight of the MoFP to help push them forward. The Bank will facilitate regular tripartite dialogue during the implementation of the operation, and with other line ministries as required, to facilitate GoSL’s own monitoring of the policy areas.

If at any time during the drawdown period the Bank concludes that the prior actions have been reversed, the Bank would promptly advise the borrower of the need for improvement and the suspension of eligibility for disbursement. A subsequent review would be necessary to confirm that the prior actions are once again being implemented satisfactorily before it would be able to grant any request for drawdown.

The DPL with a CAT-DDO is delivered as a precursor to a longer term, programmatic engagement on DRM. For example, the Bank will support the GoSL on the development of a broad risk financing strategy, which will help further identify optimal solutions for financial

protection in the country. This engagement will help address any issues arising through the implementation of the DPL with a CAT-DDO, as required by the Borrower.

VI. Risks and Risk Mitigation

Institutional risk: As has been made evident by institutional weaknesses in the face of major disasters in developed countries, there is a constant risk of an uncoordinated response to disaster. This risk can be mitigated by the operationalization of the Emergency Operations Plan, which provides a clear framework for coordinated response.

External macroeconomic risk: External shocks could impact Sri Lanka's macroeconomic framework. Rising global oil prices and depreciation of the Sri Lanka Rupee could put pressure on prices. The rise in oil prices could emanate from rising geopolitical tensions in Middle-East, particularly Syria. Continued depreciation of the Indian Rupee may have adverse consequences for FDI inflows and tourist arrivals from India together with a decline in Sri Lanka's exports to India. India represents the single largest trading partner and the single largest source of tourist arrivals. Further, since India is the single largest source for imported goods to the country (with a share of 19 percent of total imports in 2012), a depreciation of the Indian Rupee will likely fuel imports from India, which could deteriorate the trade balance, *ceteris paribus*.⁵

Internal macroeconomic risk: There are also macroeconomic risks originating from within Sri Lanka. Recent efforts at fiscal consolidation could go off track due to the inability of the authorities to collect the budgeted tax revenue and/or rising interest costs if the currency depreciates. The central government may resort to increased borrowing from the domestic banking sector resulting in possible crowding out of private sector credit. Furthermore, given that the growth in the two key export sectors, i.e., tea and apparel, remain stagnant, there is a risk that there will be a continued decline in the exports-to-GDP ratio. There needs to be a new thrust towards diversification of both product and export markets to ensure that the trade balance remains manageable.

Reputational risk: the DPL with a CAT-DDO is designed as an instrument to promote policy reform in the management of disaster risks by governments. There is a common understanding that DPL with a CAT-DDOs provide financial liquidity for a country in the event of a disaster, and the natural perception therefore that funds are used directly for reconstruction. As a DPL, the GoSL is at will to allocate resources once they are triggered in the way they wish. A reputational risk can arise if the expectation that funds are automatically available for reconstruction is not managed proactively from the outset of the operation, both across government and non-governmental stakeholders

⁵ The authorities have already taken steps curtail imports. A 100 per cent margin deposit requirement against the Letters of Credit opened with the commercial banks for the import of motor vehicles, other than buses, ambulances, lorries and trucks with effect from 27th August 2013. Earlier in July 2013, import levies on big onions were increased.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Disasters triggered by natural events have a disproportionate impact on the poor. Ninety-nine percent of people affected by approximately 6,000 large-scale natural disasters registered worldwide between 1970 and 2002 were in developing countries. According to a recent report from the Overseas Development Institute⁶, of the 11 countries most at-risk from disaster-induced poverty, three are in South Asia.⁷ By 2030, up to 325 million extremely poor people will be living in the 49 most hazard-prone countries, the majority in South Asia and sub-Saharan Africa

Disasters exacerbate the preexisting social, political, and economic factors that contributed to the vulnerability of the poor and marginalized before the disaster⁸. The poor have limited labor skills, fewer assets, and little or no savings. They have little opportunity for risk diversification and restricted access to credit. Because of this, they are less able to cope with the impacts on consumption or disruptions to income. Exogenous shocks can also increase poverty indirectly through the effects of lower economic growth, higher inflation (the poor are more vulnerable to inflation), and through consequential lower government spending for social services.⁹

In Sri Lanka, the particular vulnerability of poor communities to disasters has been the subject of research. Preliminary research has found a correlation between populations living below the poverty line, and those affected by houses damaged due to floods and landslides.¹⁰ Moreover, it is the workers in the tea estates who demonstrate particular vulnerability to shocks on the tea industry caused by natural hazards, particularly in light of the precarious livelihood of this sector.

In addition, a joint study by the World Bank and Department of statistics of Sri Lanka concludes that flood and drought in Sri Lanka have a disproportionate effect on the poor, as the livelihood of many low-income farmers depends on agriculture¹¹. Limited resources and networks make the poor more vulnerable and unable to cope and recover from natural disasters. Similar study on the effects of the 2004 Tsunami in Sri Lanka found that the coastal regions that suffered the most from the tsunami are still lagging behind the economy of the rest of the country¹². This is due to the low economic level of people in the fishing industry who could not recover from the devastation.

⁶ See www.odi.org/poverty-disasters-2030

⁷ The 11 countries most at risk of disaster-induced poverty (high numbers of people living in poverty, high multi-hazard exposure, inadequate capacity to minimize impacts) are **Bangladesh**, Democratic Republic of the Congo, Ethiopia, Kenya, Madagascar, **Nepal**, Nigeria, **Pakistan**, South Sudan, Sudan and Uganda.

¹⁰ Sri Lanka National Report on Disaster Risk, Poverty and Human Development Relationship (2009), DMC and UNDP <http://www.preventionweb.net/english/hyogo/gar/background-papers/documents/Chap3/Asia-overview/Sri-Lanka-DRAFT-march-09.pdf>

¹¹ *A Poverty Map for Sri Lanka-Findings and Lessons*, The World Bank, Department of Statistics of Sri Lanka, 2005

¹² Zane, Michael, *The Effects of Tsunami Relief Policy on the Poverty Levels in Sri Lanka*, The College of New Jersey, Economic Department

Studies in South Asia have found strong evidence on the contribution of natural disasters to exacerbate poverty and on the disproportionate susceptibility of the poor to natural disasters. A study in Bangladesh found a strong relationship between poverty and natural disasters. The study examined statistical evidence to show the significance of the impact of floods as a major cause of persistent poverty in Bangladesh. The data was partitioned into urban and rural to account for the poverty gap. The results of the study found out that flood prone districts have consistently greater headcount ratios of poverty, supporting the theory that poor people are forced to live in flood prone areas due to social and economic constraints¹³.

The proposed operation is therefore likely to have positive effects on the poor by providing support to the GoSL's policies that seek to alleviate poverty by strengthening DRM in Sri Lanka. In case of a declaration of a state of emergency, the activation of the DPL with a CAT-DDO will help to ensure the continuity of development plans, targeted at alleviating the needs of the poor. It will also ensure that resources are quickly available to respond to the needs of the affected population as it has been the case in other countries.

As part of the Bank dialogue with the country, this operation will promote the sharing of the Bank's global expertise in disaster risk reduction and attention to vulnerable populations. In particular, the Bank will seek to support the GoSL to build upon current experiences and promote: (i) improved awareness of vulnerable populations and key institutions of international human rights in relation to disaster risk management and response, (ii) adoption of international best practice in territorial planning and resettlement, legalization and livelihood support for vulnerable populations located in high risk areas, and (iv) improved inter-institutional collaboration and integration of international human rights standards in documenting, assessing, and responding to the most vulnerable population's risk in relation to natural hazards.

Environment Aspects

The specific actions supported by this DPL are not expected to have significant effects on the environment, forests or other natural resources. They would instead strengthen and complement existing laws and regulations on environmental management, such as the National Environment Act (NEA), particularly in ensuring that investments take into account DRM and climate change adaptation measures.

The GoSL has undertaken major efforts to establish an adequate institutional and organizational framework for the sustainable management of the country's natural resources. In particular, Sri Lanka has made impressive strides in developing legislation on protection, management and enhancement of the environment and on prevention, control and abatement of pollution as well as frameworks for environmental planning and environmental assessments or development projects, the most important legislation being the NEA. Efforts have resulted in broad environmental management capacity including project-specific environmental assessments. However, more effective environmental management requires progress with: (i) changes to the current system of Project Approving Agencies (PAA) for issuing environmental clearances to make the system more effective; (ii) promoting increased use of strategic and sectoral

¹³ Dasgupta, Amirita, Floods and Poverty Traps: Evidence from Bangladesh, Economic and Political Weekly, July 28,2007

environmental assessments to mitigate any serious unanticipated environmental consequences; (iii) further strengthening of the capacity of Central Environment Authority (CEA) to supervise the implementation of Environmental Monitoring Plans (EMP), which is the weakest link in the Environmental Assessment system; and (iv) appointing an independent committee of stakeholders to monitor compliance towards NEA and other related legislation.

In addition, a comprehensive National Climate Change Adaptation Strategy (NCCAS) lays out a prioritized framework for action and investment for 2011-2016. This Strategy aims at systematically moving Sri Lanka and its people towards a climate resilient future. The NCCAS mirrors and supports Sri Lanka's national development strategy as articulated in the Mahinda Chintana and is aimed at ensuring its success and sustainability. Accordingly, key findings of sector-based analysis were synthesized into an integrated framework, and structured into the following 5 Strategic Thrusts: (i) mainstream Climate Change Adaptation into National Planning and Development; (ii) Enable Climate Resilient and Healthy Human Settlements; (iii) Minimize Climate Change Impacts on Food Security; (iv) improve Climate Resilience of Key Economic Drivers; and (v) Safeguard Natural Resources and Biodiversity from Climate Change Impacts.

VIII. Contact point

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