STATEMENT OF

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TO THE SENATE FOREIGN RELATIONS COMMITTEE

CONCERNING

CORRUPTION AND THE ASIAN DEVELOPMENT BANK

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CONTENTS

I. Introduction

Mr. Chairman, Senators of the Committee, thank you very much for the opportunity to testify this afternoon concerning corruption and the Asian Development Bank (ADB). The Chairman and the Committee are to be commended for the series of three hearings on corruption and the Multilateral Development Banks (MDBs) that have been held since May. In an interconnected world where economic development and political stability are more critical than ever, the MDBs are unique institutions that have the potential to play an important and much needed role in fostering these goals in poorer countries.

However, as we heard in the previous two hearings, the cancer of systemic corruption threatens to undermine the purposes for which the MDBs were established. *As much as 20 to 30% of World Bank lending and other donor funds, such as those from the ADB, may have been stolen in Indonesia, according to the World Bank's Jakarta-based staff as expressed in leaked memos from the late 1990s.* In countries with analogous levels of corruption, the amounts may be the same or even greater.

The ADB has lent some $105 billion since its inception in 1966. Some of its major borrowers, such as Bangladesh, rank even lower on lists of international perceptions of corruption than Indonesia. ***If 30% of ADB lending has succumbed to 'leakage' over the years, that would amount to well over $30 billion in stolen funds***. You yourself, Mr. Chairman, correctly ventured that the total amount diverted from cumulative World Bank lending since the institution's inception may be as much as $100 billion. Although the World Bank is in most respects the leader in anti-corruption efforts amongst the MDBs, there are serious questions about whether current efforts are adequate to deal with the scale of corruption that occurs in some of the World Bank's major borrowing countries. These countries are also the major borrowers of the regional MDBs, including the ADB.

The situation regarding control and oversight of corruption and diversion of loans appears to be much worse at the ADB than at the World Bank. To date, while the ADB has begun to take some relatively timid measures to address corruption, these measures are so inadequate that many informed observers within and outside the ADB would characterize them as cosmetic, whatever the stated intention. Like the other MDBs, the ADB suffers from the well-documented 'culture of loan approval'—where staff are rewarded for processing and pushing loans, but not for monitoring projects and ensuring quality. ***But that the ADB suffers from a deeper organizational crisis is no secret, and over the past three years at least two non-U.S. Executive Directors of the institution have made public statements referring to a deeply entrenched institutional culture of patronage and unaccountability.***

The Donors' Agreement for the Eighth Replenishment of the soft-loan window of the Asian Development Fund, which the U.S. Treasury and the finance ministries of other countries negotiated this year for the period 2005-2008, hardly mentions the word corruption. It does not explicitly address what the ADB can do to reduce 'leakage' from its lending. There is significant discussion of emphasizing governance, reforming the personnel system, and promoting results management and development effectiveness. But if the scale of corruption is not acknowledged in an agreement to pump billions more (of which the U.S. share is to be $461 million) into the institution, it undermines confidence in the reform measures proposed.

Therefore it is deplorable that the Treasury Department has refused to allow the U.S. Executive Director of the ADB to appear today, particularly given that on May 13, 2004 the U.S. Executive Directors of the Inter-American Bank and World Bank did appear for the Committee's first hearing on corruption and the MDBs. The Treasury Department has a fiduciary duty to help ensure that the Asian Development Bank complies with its legal duty, as required in Article 14 (xi) of its Charter: to "take the necessary measures to ensure that the proceeds of any loan made, guaranteed or participated in are used only for the purposes for which the loan was granted and due attention to considerations of economy and efficiency." Although Treasury has refused to allow the U.S. Executive Director to appear before this Committee to answer questions regarding ADB corruption, it will soon ask the Committee to authorize nearly a half billion dollars of appropriations for that same institution.

In the rest of my statement I will examine in more detail the following issues: the concern of environmental organizations such as Environmental Defense over corruption in development lending; the external context of corruption at the ADB; the culture of loan approval, patronage, and lack of accountability at the ADB; studies that reveal the extent of the almost total non-implementation of much of the ADB's 1998 Anti-Corruption Policy and 2000 Operational Policy on Corruption; projects that clearly demonstrate negligence of the part of ADB in investigating corruption; the adequacy of ongoing and proposed reforms for the ADB; and specific recommendations that we believe should be implemented before fully authorizing U.S. replenishment of the ADB's soft window, the Asian Development Fund (ADF), next year.

II. Environmental Organizations and Concern for Corruption in the ADB

Environmental Defense is a national environmental organization with more than 400,000 members and supporters nationwide. While most of our work is domestic, the International Program of Environmental Defense has conducted research and advocacy concerning the environmental and social impacts of MDB lending for 20 years, and has made numerous submissions to Congressional authorization and appropriations committees regarding these institutions. A number of years ago, our concern regarding the quality of MDB lending led us to examine the issue of institutional incentives and controls at these institutions.

Why are organizations such as Environmental Defense, which are primarily focused on promoting environmentally sustainable lending policies at the international financial institutions, so concerned about corruption? The 'culture of loan approval' and 'pressure to lend,' which has been documented in the World Bank and other MDBs for more than a decade, has often also contributed to failures in the implementation of policies designed to mitigate adverse environmental and social impacts of MDB lending. This is quite clear in some examples of recent ADB projects, discussed later in this statement, such as the Thailand Samut Prakarn Wastewater Management Project and the Sri Lanka Southern Transport Development Project. Measures to address the institutional problems relating to corruption at the MDBs would also go a long way towards improving overall project quality with respect to environmental and social impacts.

III. Corruption and the ADB: The External Context

Corruption in the multilateral development banks can occur at three, interconnected levels. First, there is corruption of individual members of staff and management for personal gain. Second, there is corruption in procurement for provision of goods and services for specific investment projects. The example of the corrupt bidding practices, through agents, of international companies involved in the World Bank Lesotho Highlands Project—discussed in the Committee's July 21, 2004 hearing—provides an example. Third, there is systemic corruption on the part of government officials and ministries in borrowing countries, where substantial percentages of development assistance are stolen over years or decades, with at least passive MDB complicity. The case of Indonesia, discussed in the May 13, 2004 hearing, has become one of the best-documented and publicized examples.

There are indications that the ADB, through both its organizational deficiencies and its external lending environment, is more susceptible to corruption than the World Bank on all three levels. The following sections of this statement will examine the ADB's internal culture and effectiveness as it relates to these three types of corruption. It is important to emphasize here that the external lending environment of the ADB is extremely corruption prone and calls for an extraordinary level of due diligence—a commitment to which the institution has not shown.

The ADB's top five cumulative borrowers, and its largest borrowers in 2003, are among the most corrupt countries on earth, as analyzed in recent years by Transparency International. Its five biggest cumulative borrowers are Indonesia ($19.3 billion), China ($13.3 billion), Pakistan ($13.55 billion), India ($13.315 billion), and Bangladesh ($7.32 billion). The ADB approved some $6.105 billion in loans for fiscal year 2003, of which $1.532 billion were for Indonesia, $1.488 billion for China, $871 million for Pakistan, $275 million for Sri Lanka, and $262 million for India.

Transparency International ranks countries annually according to a Corruption Perception Index (CPI), from a possible highest rating of 10 (highly clean) to 0 (highly corrupt). In 2003, Transparency published 133 rankings: Indonesia is rated near the bottom at number 122, with a CPI ranking of 1.9. Bangladesh ranks dead last at 133 on the list with a CPI of 1.3. Pakistan, the third largest cumulative borrower and third most important borrower for FY 2003, ranks 92 with a CPI of 2.5. India ranks number 83 with a CPI of 2.8 and China number 66 with a CPI of 3.4. Moreover, a number of the ADB's smaller borrowers such as Cambodia and Laos, while notoriously corrupt, do not even have a Transparency International rating. In contrast, countries ranked in the top five such as Finland, New Zealand, and Singapore had CPI ratings ranging from 9.7 to 9.4.

Such a lending environment should call for controls on corruption as perhaps the number one institutional priority. Instead ADB management has only belatedly and timidly recognized the seriousness of the issue, despite having promulgated a good governance policy (for its borrowers, not for itself!) in 1995, an Anti-Corruption Policy in 1998, and more detailed Operational Procedures on Anti-Corruption in 2000.

My own conversations with ADB officials (some of whom were quite forthcoming, some of whom wish to remain anonymous) revealed concerns over the quality of financial reporting and accounting from borrowers. While the ADB offers technical assistance to borrowers for "governance" programs, it has not made rigorous financial reporting and accounting for its own loans a priority, which would be the first and single most important thing it could do to begin to catalyze better accounting by borrowers. I was told that the ADB now requires that financial reports be submitted in a timely and regular manner, and that ADB staff are supposed to read the reports, but it's not clear what attention is actually paid to them.

IV. A Dysfunctional Internal Culture: Loan Approval, Patronage, Lack of Accountability and Tolerance of Corruption

The ADB suffers from the same 'culture of loan approval' as the World Bank and other MDBs, with a concurrent lack of resources and commitment to monitoring and implementation. But it also suffers from a deeper institutional crisis: it is no secret that the ADB's internal culture is one that has fostered—and still continues too often to foster—a climate that turns a blind eye to corruption. Stephen Baker, a former Executive Director to the ADB representing Australia, shared his reflections with his peers in February 2001. He stressed that following the Asian financial crisis there was a "rude awakening to the damage wrought by corruption" and that the ADB still had "to get far tougher with those who 'skim and scam' on ADB projects and those governments which are party to, or allow it to happen."[1] This former ADB Executive Director also alerted his colleagues to the poor performance of the ADB: "Having previously worked under the premise that every $1 of investment must return at least $1.10, it was depressing to find from the evaluation reports that some projects returned as little as 30c on the dollar and even some of the generally successful ones only 60c on the dollar. Even more depressing was the fact that in certain sectors, the Bank kept lending and kept failing."[2]

Just fifteen months ago (June 2003), Frank Black, former Executive Director to the ADB for United Kingdom, Germany, Austria and Turkey, noted that "the Bank's appointments, promotion, appraisal and incentive systems are in need of a thorough overhaul. The system lacks transparency at present, and *there is a prevalent 'patronage' system,* whereby staff of sometimes dubious quality, can rise in the institution by aligning themselves with powerful 'patrons' in senior positions" (emphasis added).[3]

Black, in his widely circulated critique of the Bank, stated that the ADB "is perceived as very government-oriented" and "can too easily slip into playing the role of propaganda mouthpiece for some governments (and not always the most democratic or legitimate governments)." Black argues that ADB's ability to promote good governance in its borrowers is often hampered by an institutionally rooted conflict of interest where major borrowers are also shareholders. The Board itself is part of the problem since "it is almost entirely reactive to, and very effectively

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[1] Stephen Baker, "ADB—Wherefore Art Thou (Reflections of a Board Member who spent three interesting years with the Bank)," February 2001, p. 10.
[2] Ibid., p. 1.
[3] Frank Black, "The Asian Development Bank (ADB): A Unique Contribution? The Effectiveness of the Financing and Political Role of the ADB in Reducing Poverty in the Asia/Pacific Region (prepared by Frank Black, departing Executive Director for Austria, Germany, Turkey and the United Kingdom at the ADB, June 2003), p. 8.

‘contained’ by the Bank’s management, and by its ‘consensus culture.’” According to Black, “[t]oo often, and particularly in the case of institutional reform and some sensitive policy issues, this can mean either ‘no change’ or a series of backroom deals and compromises presented as ‘consensus,’ but amounting to the lowest common denominator.”[4]

These deeper institutional crises feed into and reinforce the culture of loan approval. Pushing money out the door represents the path of least resistance for a management and board that is reluctant to exercise independence and rigor vis a vis major borrowing governments. In the words of former Executive Director Baker, “Considerable energy is spent on preparing projects and programs for Board approval. Far less is spent on ensuring they are successfully implemented.”[5]

A former relatively high ranking ADB official with extensive operational experience prepared the following comments on the internal dynamics of the culture of loan approval at the ADB:

> *“The ‘organizational ethos’ of the ADB is “lending”. This is their raison d etre. The organizational structure including staffing is geared towards this. This is further reinforced with the bank recruitment, staff deployment and performance policy.”*
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> “*The personnel policy practiced over the years is heavily weighted towards loan processing rather than administration. This has its consequences. First, staff recruitment tends to favor those with project formulation and processing experience over applicants experienced in project administration. Second, the HR performance system is skewed to reward staff with demonstrated record in processing loan and technical assistance operations than those in project administration. This is seen in the number of managerial positions being occupied by staff rewarded for their performance in loan processing and perpetuating this practice.”*
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> “*In the bank, the weekly Board meeting agenda is dominated by discussions on loan proposals. Similarly, management meetings are convened to appraise loans. Performance at these meetings defines staff’s career and promotion prospects.”*
>
> “*The importance of loan administration has been largely undermined by the attention to loan approvals. The lesser attention to loan administration can lead to abuses of loan funds that are easily detected. The arduous and less ‘glamorous’ task of loan administration is relegated to staff with ‘weaker’ performance. Most loan administration staff have been less successful in project processing, relatively `less fluent’ in the bank’s working language (English) and generally ‘older staff’. Managerial attention is focused on pursuing the timely completion of project processing leading to ‘approved loans’ in line with organizational goal compared with loan administration.”*
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> “*The bank has delegated wide ranging approving authority to implementing agencies to accelerate disbursement as a sign of effective project implementation. This is often the*

[4] Ibid., pp. 4, 8.
[5] Stephen Baker, “ADB—Wherefore Art Thou (Reflections of a Board Member who spent three interesting years with the Bank),” February 2001.

area for potential abuse that unfortunately, the bank is not always in the position to fully understand. Documentation relating to contract awards is submitted to the bank, post-ante, with a certification on adherence to bank's procurement guidelines. However, it does not preclude the implementing agencies from malpractices such as collusion and price-fixing among contractors. This is difficult to detect particularly since loan administration officers are encouraged to approve such awards quickly to speed up disbursement, which is their performance measure."

"*The inadequate attention to loan administration is also reflected in the resources set aside for its staffing and supervision missions. In general, the staff team responsible for processing a loan devotes their full time attention to 'deliver' the project for approval including funds for several appraisal related missions. On the other hand, a loan administration staff has to supervise a number of projects. This includes combining several project supervision activities into a single mission. To supplement staff resources, the bank uses loan administration clerks (Filipino staff many of whom were ex-secretaries) to accompany professional staff on supervision missions. Their responsibility is to verify post-ante contract awards against claims for disbursements. The loan administration professional's main task is to report on physical implementation."*

"Some estimates of total funds corrupted from other MDBs have reached 30 percent. Internally we feel that this level of losses is the same if not higher at the ADB."

This individual has asked to remain anonymous. I believe that most knowledgeable observers inside and outside the ADB would not challenge his analysis.

In this atmosphere, ADB management has shown an almost cavalier approach to the consistent and effective implementation of its own declared policies and procedures. In response to documented examples of major violations of ADB policies in complaints before the ADB's Inspection Panel, Management has denied every alleged violation in every case: the Samut Prakarn Wastewater Management Project, the Sri Lanka Southern Transport Development Project, and most recently the Pakistan Chashma Right Bank Irrigation Project (Stage III). The first two projects are discussed in more detail in section VI of this statement.

The Chashma Right Bank Irrigation Project is the most recent ADB management response (May 2004) to an Inspection claim. This is a project for which the ADB committed $172.6 million (60% or the total project cost of $296.52 million) for a 171-mile irrigation canal along the Indus River, including the construction of 72 distribution canals, 68 cross-drainage structure, and 91 bridges. The most recent ADB financing was approved in 1999. The project area in northwest Pakistan impacts part of the Northwest Frontier Province bordering Afghanistan.. A grievance committee for the project received complaints from almost 9,000 people detailing economic hardship and livelihood losses resulting from the project. A major issue is that ADB never prepared, as required by ADB policy, a resettlement and rehabilitation action plan to address the forced displacement, land and livelihoods losses to thousands of people caused by the project's huge infrastructure footprint. In November 2002, representatives of local affected communities requested an independent inspection of the project, and the inspection finally commenced in

December 2003. ADB management issued its response to the draft inspection report in May 2004.

ADB management's expressed views on ADB policies and procedures in this May 2004 document are disturbing and revealing. Management strikes a defensive pose and asserts that no ADB Operational Policies and Procedures were violated because "[j]udgment also applies to the interpretation given to Operational Policies and Procedures themselves. It is for this reason that the ADB's 'internal laws' are not written as rule based statutes but as operational principles…. This set up… means that Management (as well as the Board) are called upon to make evaluations and decisions about what is possible and 'doable' while adhering to the *integrity and spirit* of ADB's internal laws…. With the above in mind, *Management feels it relevant to highlight that many (if not all) of the operational principles in place in the past and today are drafted on the understanding that* ***'one rule does not fit all.' Professional judgment fills the vacuum***" (emphasis added).[6]

And what a vacuum it is! The management response goes on to state that the "vacuum" for ad hoc differing applications of policy and procedures based on "professional judgment" of management "is needed in relation to all due diligence areas, including: technical, commercial, economic, financial, legal, institutional, environmental, social, gender, indigenous peoples, resettlement." To assert that "one rule does not fit all" and that "professional judgment [of management] fills the vacuum" for implementing ADB policies, including, and especially for, financial and legal procedures, policies and requirements, is an extraordinary declaration of unaccountability for an international public financial institution.

The issues of internal personnel culture and culture of loan approval are mentioned in the ADB's Eighth Replenishment Donors' Agreement for the ADF. The ADB is also preparing a new internal Human Resources strategy. Whether there is any reasonable expectation that changes will be more than cosmetic, timed in anticipation of another donor replenishment, is an open question to which this statement will return in Sections VII and VIII.

V. Evidence of Systematic Non-Compliance with ADB Anti-Corruption Policies and Procedures: Two Recent Studies

A. "Zero Tolerance"For Implementing the Anti Corruption Policy and Procedures?

In fact, it is precisely in the area of corruption where we have the most recently documented and most analytically rigorous studies of systematic ADB non-compliance with declared policies. The March 2003 study commissioned by the Washington, DC Bank Information Center, *"'Zero Tolerance?': Assessing the Asian Development Bank's Efforts to Limit Corruption in its Lending Operations,"* by attorney Steve Herz, reveals a remarkably consistent record: "We found that the ADB ***almost never*** complied with the policy requirement to explicitly address corruption issues in its reports, assessments, and evaluations" (emphasis in original).[7]

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[6] ADB, "Comments of ADB Management to the Inspection Panel on the Panel's Draft Report on the Chashma Right Bank Irrigation Project (Stage III) (Loan 1145-Pak [SF} in the Islamic Republic of Pakistan, May 2004," pp. 3-4.
[7] Steve Herz, "'Zero Tolerance?' Assessing the Asian Development Bank's Efforts to Limit Corruption in its Lending Operations" (Washington D.C.: Bank Information Center, March 2004), p. iii.

The study examined in detail the ADB's policy response to corruption, particularly its commitments under its Charter, 1998 Anti-Corruption Policy, and 2000 Operational Procedures on Anti-Corruption. It then analyzed how the ADB implemented these policies and procedures in three major stages of the project cycle: country economic and strategy studies, project appraisals, and project performance evaluations. The study examined eight recent Country Strategy reports for eight ADB borrowing nations and 18 recent project appraisal reports (known in the ADB as Reports and Recommendations of the President to the Board or RRPs) for three major ADB borrowers with high levels of corruption: Indonesia, Pakistan, and Bangladesh. Finally, the study examined 16 project completion and project performance audit reports in eight different borrowing countries.

The findings are a remarkable exposure of the culture of unaccountability and non-compliance in the ADB.

Article 14 (xi) of the ADB's Articles of Agreement states that "the Bank shall take the necessary measures to ensure that the proceeds of any loan made, guaranteed or participated in are used only for the purposes for which the loan was granted and with due attention to considerations of economy and efficiency." In 1998, the ADB published its Anti-Corruption Policy, which Herz notes, does not refer to the fiduciary requirement in the Articles of Agreement to take "the necessary measures" to ensure ADB funds are used for the purposes intended. The policy takes a narrower "more instrumental approach and grounds its anti-corruption efforts in the pursuit of development effectiveness rather than the obligation to safeguard Bank funds."[8]

The Anti-Corruption Policy specifies three priorities: "(i) supporting…effective, accountable, and transparent public administration as part of the ADB's broader work on governance and capacity building; (ii) supporting promising anticorruption efforts on a case by case basis and improving the quality of the ADB's dialogue with Developing Member Countries on a range of governance issues, including corruption; and (iii) ensuring that the ADB's projects and staff adhere to the highest financial and ethical standards."[9] The policy cautions staff about "initiatives that are largely cosmetic in nature and designed to foster the illusion of progress without the substance."[10] The Policy declares "a 'zero tolerance' policy when credible evidence of corruption exists among ADB staff or projects" and that "ADB's anticorruption effort will place particular emphasis on the implementation of practical and cost-effective preventative control measures…."[11]

For country programming and strategies, the Operational Procedures "direct management and staff to assess whether ADB projects are likely to be affected by corruption during their design or implementation, whether a country's ability to attain its national development objectives are being compromised by corruption, and whether the government is willing or able to control

[8] Ibid., p. 4.
[9] ADB, "Anticorruption," (typset version of the official policy paper approved by the Board on 2 July 1998), para. 34, pp. 19-20.
[10] Ibid., p. 26.
[11] Ibid., p. 28.

corruption. In preparing these documents management and staff are instructed to use plain language and avoid using euphemistic language that may obscure the nature of the problem."[12]

In looking at eight recent Country Strategy Papers, CSPS, (for high corruption risk Bangladesh, Cambodia, India, Indonesia, Laos, Nepal, Pakistan, Viet Nam), the BIC study found negligible implementation of the Policy and Operational Procedures. None of the eight assessed the impact of corruption on a country's ability to attain national development objectives, and none assessed in any way the government's ability and willingness to control corruption. Seven of the eight had no mention of how ADB projects might be affected by corruption during design or implementation (for Indonesia there was a general, vague mention, not in 'plain' non-euphemistic language). Only one CSP, for Indonesia, discussed how the ADB could specifically address corruption.[13] In contrast, the study examined World Bank Country Assistance Strategies for all eight countries and found that the World Bank had addressed three or four of the corruption issues explicitly and specifically for seven of the eight countries, and examined two out of four in the case of one country.

Going on to project appraisal, the study looked at 18 ADB appraisal reports (RRPs) approved by the Board in 2002 for three of the ADB's biggest, and riskiest borrowers: Bangladesh, Pakistan, and Indonesia. Regarding assessment of the borrower's management and procurement capacity, 17 of 18 RRPs had no mention of the issue. The risk of theft and misappropriation of project funds was not considered in any of the 18 reports. Fifteen of eighteen reports provided no assessment of corruption risk in the project on achieving its objectives. Finally, 13 of 18 reports proposed no specific measures to mitigate project corruption risks.

For post-project auditing, the study examined eight recent Project Completion Reports (prepared by the ADB's operations staff one to two years after completion) and eight Project Performance Audit Reports (prepared by the independent Operations Evaluation Department three years after completion). The 16 evaluation reports were selected for four of the ADB's biggest, most at risk for corruption, borrowers: Bangladesh, Indonesia, India, and the Philippines. ***The ADB had a perfect score: in none of the 16 project evaluation reports for four of the more corrupt countries on earth did ADB operations staff and performance auditors assess possible corruption in any respect.***[14]

Apparently, this is how the "ADB's anticorruption effort will place particular emphasis on the implementation of practical and cost-effective preventative control measures…." We see clearly how management's "professional judgment fills the vacuum" in interpreting ADB policies and procedures as flexible principles so that "one rule does not fit all." **No rule applies to anyone at anytime.**

The BIC study ventures four possible explanations for the miserable record of compliance, which basically restate the problems of the internal ADB management culture discussed above in Section IV. First, management has not given staff any guidance on how to assess corruption issues. It would seem that the Anti-Corruption Policy and Operational Procedures are largely

[12] Ibid., p. 5, citing ADB Anti-Corruption Operational Procedures at paragraphs 27 and 54.
[13] Ibid., p. 7.
[14] Ibid., p. 11.

cosmetic ornaments or public relations tools, rather than serious directions for ADB operations. Second, the loan approval culture still prevails, along with the concurrent lack of resources for supervision and monitoring. Third, ADB staff do not want to embarrass borrowing governments on the Board or make them lose face. Fourth, there is a lack of institutional leadership in top management, starting with the President.[15]

The "Zero Tolerance" study was discussed earlier this year with ADB officials, including the Auditor General of the institution, who has stated that he agrees with 99% of the findings. Such candor is praiseworthy, and perhaps a first harbinger of change in the attitudes of some in management. Nevertheless, the current situation remains abysmal.

B. "The ADB in its Own Words"

"Record keeping also seems to have been abandoned" "This Project did not benefit from having a logical framework" "No identification of beneficiaries was attempted, and thus no basis was provided for measuring impact on beneficiaries" "The project was implemented more or less as planned, but at greatly increased cost with substantial delays" "Overall ADB's supervision of the Project was not adequate" – Conclusions from recent ADB Project Performance Audit Reports.

When corruption is not explicitly addressed in project evaluations (as is the case of the ADB), poor performance (cost and time overruns, reported contracting irregularities, shoddy appraisal with few or no measurable indicators for project success) can often be a proxy indicator for corruption in borrowers at high risk for bribery and fraud. In July 2003, Environmental Defense released an analysis of almost all publicly available Project Performance Audit Reports (PPARs) of ADB projects in Indonesia, Pakistan and Sri Lanka.[16] Most of the PPARs were conducted in the past six and a half years, during which time the ADB's Anti-Corruption Policy has been in effect.

We found a disturbing record of poor performance, where project sustainability—whether or not a project provides lasting, long-term economic and social benefits—was lacking for the vast majority of projects: based on the sample of ADB publicly available audits at the time, 70% of ADB projects in Pakistan and Indonesia were not likely to provide long-term benefits, and 78% in Sri Lanka. It should be pointed out that in its 2000 assessment of multilateral development institutions, the bi-partisan U.S. Congressional International Financial Institution Advisory Committee (the Meltzer Commission) identified project sustainability as the key indicator for measuring these institutions' performance.

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[15] Ibid., p. 10.

[16] Stephanie Gorson Fried, Ph.D. and Shannon Lawrence, Environmental Defense, with Regina Gregory, ADB Watch, "The Asian Development Bank: In its Own Words: An Analysis of Project Audit Reports for Indonesia, Pakistan, and Sri Lanka," Environmental Defense, July 2003. In the case of Pakistan and Sri Lanka, we examined every PPAR the ADB had made publicly available on its website (23 for Pakistan, 16 for Sri Lanka); and for Indonesia we analyzed 70% of the publicly available reports, some 21 out of 30. Presumably ADB management chose to make public a representative sample of its audits, a sample which at the very least did not present a view of the ADB's record that was skewed towards worse than average performance.

In a number of these projects, clear warning signals of fraud were identified—e.g. "contracting irregularities" resulting in cost overruns and shoddy, substandard construction—without any mention or analysis of perhaps the most likely explanation: corruption. In the majority of the 49 PPARs we analyzed, project appraisal and preparation was also gravely deficient; most projects lacked coherent, measurable systems to measure the project's delivery of benefits. The lack of monitorable indicators in projects makes diversion of funds easier to perpetrate and harder to detect and prove.

A reading of the findings of these audit reports reveals poor performance and irregularities time and time again, which at the very least would call for consideration of whether or not corruption played a role. For example, the 2000 audit report for the $36.5 million ADB loan for the Sri Lanka Road Improvement Project uncovered a convoluted bidding process where rising costs reduced the planned road construction to 147 kilometers instead of 390, but the project still incurred a 23% cost overrun.[17] The 1999 audit of the Sri Lanka Walawe Irrigation Improvement Project (ADB financing of nearly $20 million) found that consultant fees were almost three times greater than appraised, accounting for 20% of construction costs.[18] The 2002 audit of the $151 million ADB loan for the Indonesia Third Local Roads Project identified 1,800 separate road contractors who were hired under "local competitive bidding procedures." There were 10,000 person-months of domestic consultants and 500 person-months of international consultants. Most of the ensuing road construction was sub-standard, using cheap unstable penetration macadam (pemac) rather than higher quality machine laid hot mix, such as asphaltic concrete. As a result, "35 percent of the penmac surfaces had severe defects within 3 years; all of these roads were likely to soon be in poor condition unless effective maintenance was applied."[19]

The lack of monitorable benefits indicators is particularly alarming for non-project program loans. Two agricultural program loans for Sri Lanka totaling $140 million lacked performance indicators, ignored the government's institutional capacity to handle the money, and indeed, lacked "a logical framework specifying quantitative performance indicators."[20] The audit of a $250 million Food Crop Sector program loan for Indonesia found "no performance indicators against which Program impact could be assessed."[21]

These and many other examples show the development cost of the ADB's refusal to seriously carry out its fiduciary duty and take necessary measures to ensure that its loans are used effectively and efficiently for the purposes intended.

[17] "The Asian Development Bank: In its Own Words," p. 90, citing Asian Development Bank Post-Evaluation Office, "Project Performance Audit Report on the Second Road Improvement Project in Sri Lanka, June 2000, paras. 11 and 19.
[18] Ibid., p. 39, citing Asian Development Bank Post-Evaluation Office. "Project Performance Audit on the Walawe Irrigation Improvement Project in Sri Lanka," December 1999, Section II, p. 3.
[19] Ibid., p. 9, citing Asian Development Bank Post-Evaluation Office. "Project Performance Audit on the Third Local Roads Project in Indonesia,"December 2002, p. 9.
[20] Ibid., pp. 40-41.
[21] "The Asian Development Bank: In its Own Words," p. 2, citing Asian Development Bank Post-Evaluation Office. "Project Performance Audit on the Food Crop Sector Program in Indonesia," December 1997, p. 6.

VI. Negligence of the ADB in Investigating Corruption in Major Projects

Non-governmental and community organizations in ADB borrowing countries have complained about financial irregularities and corruption in ADB projects for years. We see flagrant cases where corruption has been linked not only to irregular procurement and massive cost overruns but—most importantly from the standpoint of local communities—also to major changes in the location and design of large infrastructure projects. These unappraised changes have resulted in major, unmitigated social and environmental impacts. Two of the most flagrant examples are described below.

A. The Thailand Samut Prakarn Wastewater Treatment Plant

The ADB approved a total of $230 million in loans for this project. When the original $150 million loan was approved by the ADB Board in 1995, the project was appraised as two industrial wastewater treatment plant on both sides of the Chao Phraya River in Thailand. The ADB board approved a loan for a project which in effect was never implemented: following the loan approval the Thai Pollution Control Board moved the site of the plant 20 kilometers away to build a single plant in the Klong Dan district. Only one company—the NVSPKG Joint Venture—submitted a bid for the construction, a violation of both Thai and ADB procurement rules.

Building the plant on the changed site resulted in a cost overrun of 87% (from $507 million to $946 million; among other things, a pipeline had to be built to transfer the wastes from the industrial plants near the original site) and serious environmental, social and economic impacts on some 60,000 villagers—most of them dependent on coastal fisheries that would be polluted by the wastewater plant discharges—living adjacent to the new site. To finance the cost overruns caused by the change of location, ADB management asked the ADB Board to approve an $80 million supplemental financing loan in 1998. ADB policies and procedures clearly required a reappraisal of the project at that time, since it was not the project that was approved in 1995, but this was not done. Nor were any of the requisite environmental impact or social studies conducted based on the new site.

Over the past several years, the Thai press has printed numerous articles alleging that this seemingly illogical and costly site change was linked to a massive land fraud conspiracy among various Thai government officials. For example, the *Bangkok Post* reported on November 15, 2002 that the Thai Development Research Institute found the company that won the bid was linked to a former Science Minister and his relatives, and the then deputy Commerce Minister and the Deputy Industry Minister happened to be co-owners of the land at the new site. A major consultant to the project, Seatec International Asia Technology, was owned by a former politician who also jointly owned some of the land at the new site:[22] "Thai law enforcement authorities believe that PCD [the Thai Pollution Control Authority, Executing Agency for the project] officials, executives of the Joint Venture, and the owners of the Klong Dan property

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[22] Supawadee Suanpoolthong, "A Case Study of Corruption: Politicians exploited plan 'at every stage', *Bangkok Post*, November 15 2002.

conspired to inflate the purchase price of the [land] parcels by as much as 1000 percent."[23] Thai authorities have brought criminal indictments against senior officials of the Pollution Control Authority, real estate developers, and executives of the contractor.[24]

Several Thai Government entities launched investigations into corruption in the project. A Special Committee of the Thai Senate "found corruption at every stage of the project."[25] The Thai Prime Minister stated last year that the ADB project was "riddled with corruption." This has become one of the biggest, most public corruption scandals in Thai historyand more remains to be uncovered: "Many in Thailand now suspect that the collusive land deals are only the tip of the iceberg of the corruption on the Samut Prakarn project, and that far grander corruption is likely to have occurred in the procurement and construction of the project."[26]

So how has the ADB responded to corruption allegations in Samut Prakarn? A June 2000 ADB Special Review Mission to Klong Dan found no evidence of irregularities in the land acquisition process. The affected communities at Klong Dan then filed claims of violations of ADB policies before the ADB Inspection Panel and the ADB Anti-Corruption Unit of the Office of the ADB Auditor General (OAG). But the Inspection Committee of the ADB's Board, which has to approve inspections, refused to allow the Panel to pursue the corruption allegation, arguing that it was outside the Panel's jurisdiction and that the Anti-Corruption Unit was conducting its own investigation. The Anti-Corruption Unit never conducted a full investigation, arguing that the Thai government was already on the case. The ADB mainly examined the allegation that an ADB official involved with the project had a conflict of interest, and concluded by rejecting the allegation.[27] The Auditor General of the ADB has stated that while the ADB did not release its internal findings to the Thai authorities, it did pass on some "tips" to them.

Meanwhile, ADB management's February 2002 response to the Inspection Panel investigation claimed there were no violations of ADB policy and procedures in the way the project was conducted. The Inspection Panel released its report in March 2002, and found violations of six major ADB policies, including management's failure to conduct a complete reappraisal of the project when supplemental financing was requested in 1998. After a heated Board discussion, with some major borrowing countries arguing against the findings of the Inspection Panel, the Board basically endorsed the report's recommendations for remedial measures to address the needs of the affected population, but did not address any internal issues concerning violations of ADB policy and procedures, let alone corruption.[28]

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[23] Steve Herz, "'Zero Tolerance?' Assessing the Asian Development Bank's Efforts to Limit Corruption in its Lending Operations" (Washington D.C.: Bank Information Center, March 2004), p. 22, citing *Bangkok Post*, "Klong Dan Wastewater Plant Scandal: Vartana, Nine Others Accused: Graft Report Names VIPs, Senior Officials (11 June 2002); and *The Nation* (Bangkok)," Making the Case for Graft at Klong Dan," (18 July 2003).
[24] Ibid., citing citing *Bangkok Post,* "Klong Dan Wastewater Plant Scandal: Vartana, Nine Others Accused: Graft Report Names VIPs, Senior Officials (11 June 2002).
[25] Luntharimar Longcharoen, "Slap in the ADB's Face: The Khlong Dan Wastewater Treatment Project Corruption Scandal," TERRA (Towards Ecological Recovery and Regional Alliance), Bangkok.
[26] Herz, "Zero Tolerance," citing and *The Nation* (Bangkok)," Making the Case for Graft at Klong Dan," (18 July 2003).
[27] See Herz, pp. 24-25 and footnotes.
[28] See Bank Information Center, Washington D.C., "BIC Project Factsheet #8: The ADB funded Samut Prakarn Wastewater Management Project in Thailand," Updated July 2002.

In early 2003, the Thai government declared the contract for the plant null and void, and the Pollution Control Department announce that it is pursuing legal actions against the contractors to sue for recovery of all funds paid under the contract. All consulting contracts have been terminated.[29]

The plant remains unfinished and the numerous legal actions filed by Thai authorities are unresolved. The ADB closed both loans for Samut Prakarn in December 2003; the 1998 supplemental loan of $80 million for cost overruns and almost $131.7 million of the original 1995 $150 million loan had already been disbursed. The ADB cancelled the balance of $18.3 million. None of the remedial measures to address the harm done to local communities have been carried out.[30]

The continued lack of a full investigation of the ADB's responsibility for not monitoring, supervising, and addressing the massive corruption in this debacle is a scandal. Certainly once the corruption allegations and huge cost overruns began to surface in the late 1990s, it could and should have intervened, demanded a full forensic audit of the project, and halted disbursements on loans. What we have instead is the observation of the Board Inspection Committee's February 28, 2002 response to the Inspection Panel (which was not allowed to address corruption): ***"A sudden increase of $421 million in the estimated cost of a recently approved ADB project is a significant event."***[31]

And what has the ADB learned? Following the second hearing of this Committee on corruption and the MDBs in July 2004, the *Far Eastern Economic Review* published an article posing that very question to ADB officials. The director of the ADB's Mekong Department declared "we learn from Samut Prakarn as much as we learn from other projects."[32] Given the ADB's record, this is not encouraging.

B. The Sri Lanka Southern Transport Development Project

The Sri Lanka Southern Transport Development Project is an ongoing controversy with some analogies to Samut Prakarn: after the ADB Board approved loans for a major infrastructure project that was appraised in one location, the location was changed, causing massive cost overruns, environmental damage, and economic hardship for affected populations. Evidence of procurement irregularities in the ADB-funded project were publicized in the Sri Lankan press. The lead contracting company reportedly bribed the project head who was subsequently dismissed by the government. Affected communities filed an Inspection Panel claim in 2001, and again in 2004 after their original claim was rejected by the ADB Board Inspection Committee. The Board Inspection Committee reaffirmed management's assertions that no policies were violated, despite the recommendation of an Inspection Panel member that an inspection proceed. Although the corruption charges became a widely publicized national scandal, the ADB

[29] Asian Development Bank, "Samut Prakarn Wastewater Management Project, Fourth Semi-Annual Report to the Board of Directors on the Implementation of the Recommendations of the Board Inspection Committee as Adopted on 24 March 2002," April 2004.
[30] Ibid.
[31] ADB Board Inspection Committee, "Inspection Request, Samut Prakarn Wastewater Management Project," 28 February 2002, Para. 38, p. 7.
[32] Christopher Gay, "Thai Project Yields Graft and New Policies," *Far Eastern Economic Review*, July 20, 2004.

continues to turn a blind eye to mounting evidence of major procurement irregularities, cost overruns, and corruption in this $90 million loan.

The Sri Lanka Southern Transport Development Project involves the construction, under the authority of the government Road Development Agency (RDA), of a high-speed highway link from the capital, Colombo, to the Southern city of Mataria. Much of the original route and area of impact for the road (a trace three kilometers wide) was moved to a different location after the project was appraised and approved. **The changed road route is**, according to the June 4th complaint submitted to the ADB by Sri Lankan community groups, **twice the cost of what was presented to ADB Board when it approved the loan**.[33] The result is that the number of households displaced and destroyed by the construction more than doubled, to at least 1,315, as opposed to the environmental assessment of the original route, which affected 622 houses.[34] The altered route will destroy a valuable wetland, 1,000 hectares of rice paddies, rubber, tea, fruit and vegetable gardens belonging to the local inhabitants. Five temples will be damaged. The affected communities were not consulted, and the ADB, the claimants allege, has violated its environmental, social and resettlement policies.

The affected communities filed a lawsuit against the Road Development Authority (RDA) and won a judgment from the Sri Lanka Supreme Court in January 2004 that RDA had violated both the National Environmental Act and the rights of the petitioners under the Sri Lankan Constitution**.**[35] **To violate the laws of its borrowers is a blatant contravention of ADB policies for projects it finances, monitors and supervises.**

Allegations regarding contracting irregularities emerged in Sri Lankan newspapers in 2001 and 2002, which were confirmed by a parliamentary Committee on Public Enterprises. In the bidding process for the project, 29 companies applied, and three met the pre-qualification bidding procedures, based on a number of considerations, including the financial condition of the prospective contractors. A Japanese company, Kumagi Gumi, did not meet the pre-qualification criteria[36], and in fact had a negative financial worth. Kumagi hired an agent, Access International, to help win the contract. As is typical with this sort of arrangement, Access would win a hefty fee if it paved the way, as it were, for a successful contract award for its client. Sri Lankan newspapers reported that Access had influential political connections, including in the Prime Minister’s Office.[37] Access is alleged to have bribed the RDA project official, for example by installing a new diesel generator in his home, giving him the use of a new SUV, and promising financial rewards if Kumagi won the contract.[38] This use of agents as motors of

[33] Joint Organization of the Affected Communities on Colombo-Matara Highway, “Submission of Complaint: Southern Transport Development Project Sri Lanka, Loan SRI 1711,” 4th June 2004 (complaint submitted to the Asian Development Bank Special Project Facilitator as part of the revised ADB inspection claim process), p. 3.
[34] Ibid., p. 2.
[35] Ibid., Appendix 2 containing details of Inspection Request and new evidence, and Appendix 9, Supreme Court Judgment.
[36] To pre-qualify companies had to score 60 points in an evaluation framework assessing their financial stability, technical capacity etc. The pre-qualifying companies had scores of 95, 79 and 75. Kumagi’s score was 54.
[37] Frederica Jansz, “COPE shoots down Southern Highway,” *Sunday Leader* (Sri Lanka), October 27, 2002; Frederica Jansz, “Of Highways and Backroom Access,” *Sunday Leader* (Sri Lanka), November 1, 2001.
[38] Ibid.

corruption to win contracts in some respects recalls the case of the Lesotho Highlands Project, discussed in the Committee's July 21, 2004 hearing**.**

After the pre-qualification process was complete, the ADB reportedly sent a letter to the Sri Lankan Treasury requesting that Kumagi Gumi nevertheless be considered as a bidder on the project. Three companies, including Kumagi, participated in the final bidding; only Kumagi was allowed to submit a second alternative bid. Kumagi knowing the lowest bid of the other two companies, was naturally able to submit another, lower bid, and win the contract. All of this is recounted in two Sri Lankan newspaper articles, which I have submitted for the record. In the aftermath, the bidder that would have under normal procedures won the contract, protested, repeating the same allegations, and threatened to bring legal action.

The Sri Lankan parliamentary Committee on Public Enterprises (COPE) conducted an investigation, and concluded that both national government procurement guidelines and those of the ADB had been violated.[39] The Attorney General of Sri Lanka, when asked how Kumagi could have won the contract in violation of national and ADB tender guidelines, reportedly stated: "Kumagi Gumi had been accommodated purely on a suggestion by the ADB on February 13, 2001, particularly since it is an ADB funded project and the guide on pre-qualifications specifically provides [in such cases] for ADB approval."[40]

When the ADB Anti-Corruption Unit undertook its first mission to perform spot procurement audits in a borrowing country last year, it went to Sri Lanka, but did not look at the Southern Transport Development Project.[41] According to ADB staff, they do not wish to pursue anti-corruption claims against a project where an Inspection Panel claim may be underway or pending. This is truly a perverse and counter-productive approach, since not only does the Inspection Panel not appear to investigate corruption, it is likely that projects with Inspection Panel claims underway may be precisely the ones where corruption abuses may be better documented.

Meanwhile, the STDP project proceeds and Kumagi remains the contractor. Neither ADB management nor the ADB Board appear to be interested in investigating the extremely serious procurement irregularities and cost overruns in this case.

The June 2004 complaint of affected communities notes:

"The ADB Board of Directors approved a project which was significantly different to the one being implemented. ADB management is disbursing funds for a Project that is different from the one approved by the Board in 1999. ADB management has not carried out a full review of the Project to ensure that the current project is in compliance with ADB policies nor has it sought approval for the Project's increased costs."[42]

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[39] Ibid.
[40] Ibid.
[41] The Anti-Corruption Unit examined another project, and no corruption. It found weak financial controls which could have been exploited for corruption if corruption were present in the project.
[42] Ibid., p. 4.

This would seem to be a clear, prima facie case of ADB management and its Board failing to fulfill its fiduciary duty under the Articles of Agreement to "take the necessary measures to ensure that the proceeds of any loan made, guaranteed, or participated in are used only for the purposes for which the loan was granted…."

VII. What is the ADB Doing to Combat Corruption?

In 2001, a departing Executive Director made the following comments to his colleagues on the Board and to the management and staff of the ADB:

"Perhaps one of the most significant breakthroughs that has resulted from the Asian Crisis is the rude awakening of the damage wrought by corruption. Unfortunately this realization is yet to translate into a widespread appreciation of what amounts to 'good governance' in the form of transparency, accountability and responsibility, but at least it is a beginning. But the real question for an organization such as the ADB is 'where do you start?'"

*"**My view is that it has to firstly start at home.** For example in relation to contracts, not only must the Bank be exemplary from within (and I have little to criticize on that account), but also, **in its lending operations, the standards applied must be of a high order and strictly enforced. We have to get far tougher with those who 'skim and scam' on ADB projects, and those governments which are party to, or allow it to happen.** That may result in lower lending levels, but ultimately the outcomes will reward the effort, and send clear signals to the donors and the region that ADB is delivering a graft-free product to the ultimate benefit of the poor which it seeks to assist. **With each product there should be a 'warts and all' assessment of leakage."**[43]*

However, in the past few years the ADB has failed to systematically apply its Anti-Corruption Policy and Procedures. It has not investigated the most flagrant, scandalous and well publicized examples of corruption, such as the Thailand Samut Prakarn Project and the Sri Lanka Southern Transport Development Project. This lack of institutional leadership and managerial integrity concerning a public international financial institution's most basic fiduciary duty is most disturbing.

Conversations with ADB staff and Executive Directors' offices reveal differing perspectives on the institution's commitment to fight corruption. Some assert that over the past year ADB management has finally started to realize the seriousness of the issue and there is a new resolve to deal with the problem. The ADB's Auditor General is both candid and hopeful, but concedes that change is just beginning and progress is fragile. Some senior staff are deeply cynical about the institution's ability to change, noting that cosmetic commitments to reform come in cycles in anticipation of new ADF replenishments or ADB capital increases.

With these caveats in mind, we shall examine the anti-corruption potential of several ongoing initiatives: A. the Donor's Report for the Eighth ADF Replenishment (2005-2008); B. Performance Based Allocation of country lending; C. halting disbursements on loans when borrowers refuse to address corruption; D. the new Human Resources Strategy; E. an ongoing

[43] Stephen Baker, "ADB—Wherefore art thou? (reflections of a board member who spent 3 interesting years with the Bank)," p. 10.

review of the implementation of the ADB's Anti-Corruption and Governance policies; F. the new information disclosure (Public Communications) policy of the ADB, still in draft revision; G. the role of the Anti-Corruption Unit in the Auditor General's Office (OAG).

A. The June 2004 Donors' Report for the Eighth ADF Replenishment

The ADF IX (Eighth Replenishment) Donor's Report[44] reveals a general awareness of institutional problems in the ADB, but, as noted above, barely mentions the word corruption. The Donor's Report does not address the scale of potential 'leakage' from ADB lending, let alone suggest anything as specific as the short suggestions made in Stephen Baker's farewell observations to the Executive Board in 2001. It does emphasize a "Managing for Development Results (MfDR)" framework, to be administered by a Results Management Unit (RMU): "MfDR at ADB will incorporate measures of effectiveness, efficiency, client satisfaction, and staff satisfaction. The RMU is developing these indicators drawing on global best practices…."[45] With respect to specific measures to combat corruption in ADB loans, this is not very illuminating.

The Donors' Agreement notes the need for a "merit-based culture" and that "the current incentive structure is weighted towards new lending; they [donors] suggested that ADB reorient incentives towards implementation and development outcomes." To that end a new Human Resources Strategy is being developed. "ADB is planning early remedial action, including: (i) revising staff incentives to promote greater attention to project quality rather than lending targets…(iv) implementing a human resources strategy focused on improving performance management and providing for greater accountability."[46] It is very difficult with commitments in such general, vague language to assess how deep or effective they are; the credibility of such proposals lies in the details and implementation. The avoidance of any specific discussion in the text of glaring problems in ADB performance, and above all the almost total avoidance of the corruption issue, can only fuel serious skepticism.

B. Performance Based Allocation

The Donors' Report cites improving the Performance Based Allocation (PBA) of ADF resources. The promotion of Performance Based Allocation in the MDBs was mentioned by Treasury Under Secretary for International Affairs John Taylor in testimony before this Committee on July 21, 2004. The idea is to allot lending based on overall country performance, as assessed by ADB-promoted indicators. The ADF IX Donors' Report proposes a greater significance of PBA for country lending allocations, and an increase of the effective weight of governance considerations in the PBA to 50%.[47]

The ADB has had a PBA system in place since 2001. This system does not appear to have had any impact on the implementation of the Anti-Corruption Policy and Procedures, nor caused any perceptible change in management's willingness to investigate even the most glaring corruption

[44] Asian Development Bank, "ADF Donors' Report: Development Effectiveness for Poverty Reduction," June 2004.
[45] Ibid., pp. 6-7.
[46] Ibid., pp. 7-8.
[47] Ibid., p. 16.

scandals associated with ADB projects. Although a revised PBA system could have the result of reducing lending allocations to borrowers that rank low on the Transparency International Index, many of the ADB's major borrowers fall into this category. Moreover, allotting resources to borrowers based on general 'governance' rankings would seem to have little relevance to stopping actual ongoing corruption of ADB resources if the ADB itself has no idea of the extent of 'leakage' from its country lending.

C. Suspending Loans When Borrowers Do Not Address Corruption

One unambiguously promising development has occurred in the past year: the reported halting of disbursements on two loans to Indonesia because of corruption concerns. Although the 1998 ADB Anti-Corruption Policy provides for this type of recourse, until last year it had never been utilized. Reportedly ADB management and the Board are considering halting disbursements on a third loan to Indonesia, again for corruption.

D. The New Human Resources Strategy

The Donors' Report also refers to new ADB Human Resources Strategy which was discussed yesterday (September 27) by the ADB's Board. The Human Resources Strategy contains a somewhat franker acknowledgement of ADB's institutional problems: 'There is a widespread perception that the internal appointment and promotion processes are not transparent and are not structured to ensure merit-based decision making….**Staff consider that there is undue non-disclosure of information about the processes, and combined with the lack of objective criteria for recruitment and selection, they do not have an appropriate level of information to substantiate decisions. These factors create a strong level of distrust and cynicism about how the organization makes HR decisions."**[48] There is a grotesque irony here: it is clear that ADB staff complain that they suffer from the same lack of access to information, and arbitrary, unaccountable non-implementation of ADB policies—at least concerning human resources management—that communities and NGOs affected by ADB projects constantly protest.

The new Human Resources Strategy proposes general measures that in one sense we all can agree with: a "Focus on Results" and "Linkage Between Performance and Incentives" looking at, *inter alia*, "internationally accepted best practices in its HR management policies and practices."[49] But exactly what results and incentives is the strategy referring to, and how will these plans be implemented?

The Summary of the Action Plan notes that the "lack of objective criteria to aid selection for each position" will be remedied by the establishment of "an ADB-wide competency framework and skills inventory" by the end of 2004. A "stronger linkage between salary increase and improved performance evaluation to ensure high level performers are rewarded with higher salary increases" will be established. Finally, the Action Summary states that to establish a "clear understanding of unacceptable behaviors and consequences" for staff through 2005 there will be "a more effective internal governance system," "mandatory code of ethics seminars for

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[48] Asian Development Bank, "Human Resources Strategy: Revised Draft for Discussion," 5 July 2004.
[49] Ibid., p. 8.

all staff," and a "review and strengthen[ing of] policies, processes and appropriate sanctions to ensure staff compliance."[50]

In the July 5, 2004 "Revised Draft" of the Human Resources Strategy, there is no mention of the priorities expressed in the ADF Donors' Report of "reorient[ing] incentives towards implementation and development outcomes," "promot[ing] greater attention to project quality rather than lending targets"—let alone any reference to country lending "leakage." The "Summary of Actions" in the Human Resource Strategy does not contain the slightest indication of what the specific content or orientation of the new performance indicators will be. Reading the text literally, one could fill in almost any possible set of institutional priorities, goals and values. It is a document proposing purely instrumental measures which are almost completely disconnected from the very real corruption and project performance problems that threaten to undermine the ADB's very mission.

E. Reviewing the Implementation of the Anti-Corruption and Governance Policies

The ADB is also conducting a review of the implementation of its Governance and Anti-Corruption Policies to consider "the governance and anticorruption priority actions for the period 2005-2009."[51] The studies of NGOs discussed in Section V ("Zero Tolerance" and "The ADB in Its Own Words") have already, as one staff member told us, done a significant part of the work the ADB should have done itself. The Committee should be kept appraised of the progress of this effort, particularly regarding the "priority actions" that the review will identify for the next five years.

F. Revised Public Communications Policy

The ADB is currently revising its "Public Communications" [information disclosure] Policy. Non-governmental groups have welcomed progress in this area, noting that the draft proposals of the ADB do go beyond the current disclosure standards at some other MDBs.[52] But there are a number of critical areas of particular relevance to assessing the ADB's corruption efforts where more information should be disclosed—starting with, for example, more detailed disclosure of the ADB's own operational budget, resource allocation, and expenditures and outlays.[53]

G. The Anti-Corruption Unit

Finally there is the role of the Anti-Corruption Unit itself. The ADB Anti-Corruption Unit, with five professionals, appears to be understaffed in relation to the 55-person strong Department of Institutional Integrity (INT) at the World Bank. According to the report undertaken by Richard Thornburgh and his associates in July 2003 indicate that the World Bank plans to further

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[50] Ibid., pp. 10-16.
[51] ADB, "Fighting Poverty in Asia and the Pacific: Achieving Results Together. Review of the Implmentaiton of the Governance and Anti-Corruption Policies" (ADB internal document, 6 pages), p. 1.
[52] Letter of Jennifer Kalafut and Mishka Zaman, Bank Information Center, to Mr. Robert Salamon, Principal Director, Office of External Relations, Asian Development Bank, May 28, 2004.
[53] Ibid., p. 6.

increase its anti-corruption staffing levels.[54] In the case of the ADB, with approximately $6 billion a year in loan commitments compared to the World Bank's $24 billion, an appropriate staffing level for the Anti-Corruption Unit should be at least around14.

The Anti-Corruption Unit, which is under the authority of the ADB's Office of the Auditor General (OAG), is primarily reactive in its function, investigating cases of alleged corruption when someone files a complaint. An Oversight Committee (analogous to the World Bank Sanctions Committee) rules on whether individuals and firms should be blacklisted and barred from future ADB business (usually for a limited period of several years). With a much smaller staff than the World Bank's INT, Anti-Corruption Unit investigations have lead to the debarment of 207 firms and individuals, as opposed to 288 to date at the World Bank. The World Bank makes its debarments public, but the ADB does not. The Thornburgh reports on fighting corruption at the World Bank emphasized in the strongest terms the desirability of automatic publication of debarments.[55]

The rationale for not naming debarred companies and individuals at the ADB seems to be two-fold. First, the news of debarment supposedly spreads rapidly in the business and consulting community, since debarred firms doing business in the Asia-Pacific region have to alert possible business partners of their status for every prospective ADB contract. Second, large, powerful firms bring tremendous political pressure to bear when confronted with potential debarment. Public debarment would likely make this pressure on the ADB, given its closeness to governments, even more intense. It is true that some major industrialized donor nations play an extraordinarily hypocritical role in lobbying for their businesses behind the scenes at the MDBs. ADB staff informed us that the Ambassador to the Philippines of a donor country directly protested the prospective debarment of a major company for corruption, claiming that the ADB Anti-Corruption policy was not intended to have such consequences. Nevertheless, the argument for automatic publication of debarments is strong, I will return to it in my summarizing recommendations.

Since the Anti-Corruption Unit serves a primarily reactive function, it is at best only one part of an effective strategy to address corruption. Proactive and preventative measures, as the Thornburgh World Bank reports stress, are equally important. The Anti-Corruption Unit has begun, despite its limited resources, to undertake proactive spot procurement audits of projects. As it is, the effectiveness of the Anti-Corruption Unit is also limited by the restrictions and limitations ADB Management and the Board have put upon it. For example, there appears to be a de facto rule that the Anti-Corruption Unit will not conduct pro-active investigations of projects if an Inspection Panel claim is in process or pending, nor when there is an ongoing government corruption investigation. But these are precisely the cases where there may be greater evidence of ADB negligence or complicity.

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[54] Dick Thornburgh, Ronald L. Gainer, Cuyler H. Walker, "Report Concerning the Proposed Strategic Plan of the World Bank's Department of Institutional Integrity, and the Adequacy of the Bank's Mechanisms and Resources for Implementing that Strategy," July 9, 2003, p. 6.

[55] Dick Thornburgh, Ronald L. Gainer, Cuyler H. Walker, "Report Concerning the Debarment Processes at the World Bank," August 14, 2002, pp. 82-83.

VIII. Conclusion and Recommendations

Mr. Chairman, Richard Thornburgh and his colleagues made the following observation concerning the World Bank, which I believe applies even more urgently to the Asian Development Bank:

> *It is important to recognize that any responsible business would have been attempting **from the time of its inception,** to stem fraud and corruption that interfered with its mission. In the Bank, however, senior management began to acknowledge the problem openly only in 1996—after a half century of operation and **after significant amounts had already been lost to fraud and corruption**. **The Bank has a lot of catching up to do.***[56]

In the Asian Development Bank there is still a question as to what extent senior management has even "began to acknowledge the problem."

We have seen the documented non-implementation of the Anti-Corruption Policy and Procedures and the unwillingness of ADB management to investigate some of the most flagrant and well-publicized cases. Current organizational plans at the ADB do not explicitly address the issue of corruption, let alone propose explicit measures to reduce it. One reads the ADF Eighth Replenishment Donors' Report, and the July 2004 draft Human Resources Policy, and comes away with the impression that major 'leakage' of ADB loans and procurement abuses are hardly a problem. The Performance Based Allocation system at the ADB, in place since 2001, seems to have had little impact on Management's commitment to implementing the Bank's Anti-Corruption Procedures and to investigating controversial cases. General governance rankings and corresponding country lending allocations will not address the corrupt diversion of ADB resources if the institution itself is not assessing corruption risk in its own country strategy and lending instruments. The most positive development at the ADB has been the willingness to halt disbursements on two loans when the borrower was not adequately guarding against corruption. But such actions are insufficient and long overdue.

Mr. Chairman, we believe the record of the ADB in addressing corruption is so poor that it would be irresponsible to authorize hundreds of millions of dollars for this institution—as Treasury will ask the Committee to do in the coming year—without a clearer idea as to the steps ADB is taking to implement reforms that will effectively address corruption. Some of these reforms are elaborated as recommendations below.

Recommendations

In the course of these hearings, a number of quite detailed and relevant recommendations were made by other witnesses which also apply to the ADB. The testimony of Manish Bapna of the Bank Information Center (BIC) on May 13, 2004 sets forth a framework of recommendations

[56] Dick Thornburgh, Ronald L. Gainer, Cuyler H. Walker, "Report Concerning the Proposed Strategic Plan of the World Bank's Department of Institutional Integrity, and the Adequacy of the Bank's Mechanisms and Resources for Implementing that Strategy," Juuly 9, 2003. pp. 5-6.

which we strongly endorse. Carrying out a number of these recommendations would in effect simply be a matter of rigorously implementing the ADB's existing Anti-Corruption Policy and Operational Procedures on Anti-Corruption.

A. The First recommendation of the May 13, 2004 BIC testimony calls for **"Evaluating Corruption Risks in Project and Sector Operations Explicitly**." **The ADB should rigorously implement its Anti-Corruption Operational Procedures to explicitly assess corruption risk in its country strategy programs, project appraisal, and project performance evaluation reports.** This will require, as the BIC statement notes, the development of clear diagnostic tools and indicators for staff to conduct a rigorous assessment of corruption risks for different sectors and types of loans.

B. The second recommendation calls for **special attention to and methodologies for risky sectors and loans: for example, extractive industries (oil, mining and gas), large infrastructure, and private sector operations, and, we would add, for non-project, program loans.** With respect to extractive industries, a comprehensive set of recommendations can be found in the World Bank commissioned Extractive Industries Review (EIR). One of the most important recommendations would require revenue transparency concerning royalties and fees paid to borrowing governments by private extractive companies supported by the MDBs, and ensure that revenue management systems are in place to account for the pro-poor uses of those revenues.

Regarding program lending, former ADB Executive Director Frank Black told his colleagues that the ADB, in comparison to the World Bank**, "has much weaker in house capacity in managing programmatic lending."**[57] Since the ADB has increased programmatic lending in recent years, diagnostic tools and indicators to assess, monitor and address corruption risks in programmatic lending should be a top priority.

C. Enhancing Transparency and Disclosure is a critical preventative measure to reduce the likelihood of corruption in ADB operations. **The ongoing revision of the ADB Public Communications Policy presents a timely opportunity for progress**. The Bank Information Center and other NGOs have submitted a number of recommendations for the improvement of the current draft Public Communications Policy, such as:

1. The ADB should start by releasing more detailed information on its own budget, including information on its internal allocation of resources, and actual expenditures and outlays. It should provide a transparent, public and detailed account, for example, of how the ADB will allot more budgetary and staff resources for monitoring and improvement of project performance and quality, including addressing corruption, as opposed to loan preparation and approval.

2. The ADB should routinely disclose documents in draft form, before final decisions are made on a policy, project or program. One of the main purposes of disclosure, of course, is to obtain input to improve the final policy, project or program.

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[57] Frank Black, departing Executive Director for Austria, Germany, Turkey and the United Kingdom, ADB, "The Asian Development Bank (ADB): A Unique Contribution? The Effectiveness of the Financing and Political Role of the ADB in Reducing Poverty in The Asia/Pacific Region," June, 2003, p. 4.

3. Civil society organizations have called upon the ADB to disclose Aide Memoires, documents produced throughout the project cycle that outline Bank and Borrowing Government agreements on steps taken in project development and implementation. Disclosure of Aide Memoires would be particularly useful in the anti-corruption fight by providing interested and affected civil society groups information on specific commitments their governments are supposed to be undertaking with ADB money. It should be pointed out that the IMF now discloses Country Letters of Intent, which are documents in which governments describe what steps and measures they have committed themselves to under IMF Standby Agreement loans.

4. The proceedings of the Board of Directors should be open to the public. Transcripts and summaries should be publicly available. This would be very important step towards holding the Board itself more accountable for oversight, including fiduciary oversight, of ADB operations. As noted by former ADB Executive Directors Baker and Black, the Board is too often divided and/or weak in performing its basic oversight duties. Great transparency of its proceedings will help create incentives for better and more effective Board performance.

5. Greater access to information for project beneficiaries and affectees will also be an added brake on corruption. The ADB must make translation of certain documents (pertaining to project planning and implementation stages) mandatory, and must employ more proactive means of seeking opinions of those who stand to gain or lose from the ADB's interventions.

6. Finally, access to information needs to be better organized and centralized: all relevant project information should be collected on a single place on the Bank's website; and ADB public information centers need to be established in all its borrowing countries.

D. Changing the internal culture and institutional incentives. This is perhaps the most important and challenging issue. The main vehicle at present for advancing this agenda appears to be the new Human Resources Strategy. Yet, as noted, drafts of the policy have almost no reference to corruption nor specifics on how staff would be evaluated in addressing the issue. The Committee should ask for clarifications from Treasury on exactly how the new Human Resources Strategy will systematically address corruption risks in ADB operations.

For example, there are specific well-designed 'business tools' that the ADB and other MDB staff could and should be required to use to guard against corruption. Transparency International in the UK has developed a number of check-lists and questionnaires for use in banks and international agencies conducting due diligence in the Construction and Engineering Industry. A recurring problem in international procurement is the use of corrupt agents to win contracts for bidders. Transparency International, U.K. has developed a comprehensive "Agency Questionnaire" along with a guide to evaluating answers with respect to likely indicators of corruption (see www.transparency.org.uk).

Finally, ADB Management's decisions in areas besides the Human Resources Strategy, such as the allocation of resources and staff for implementation of the Anti-Corruption Policy, decisions to release more information as described in sub-section C, decisions to proactively investigate corruption scandals, and to halt loan disbursements in certain cases, will be indicators of a changed internal culture.

E. Galvanizing the Board in its Oversight and Fiduciary Duties

Stephen Baker described his first impressions when he assumed is position as an Executive Director as frustrating ones: "The impression gained was that the role of the Board was restricted merely to endorsement of management initiatives….During casual discussions with staff it became apparent that the Board was regarded by some as more of a liability than an asset, or to quote, 'a waste of money.'"[58] Frank Black, another departing Executive Director, told his colleagues in June last year that "while virtually all donor and some borrowing shareholders have concerns about the Bank's internal governance and a commitment to promoting institutional reform, the Board, at least as it operates at present, does not provide sufficient impetus."[59]

Although we believe that the U.S., along with some other shareholders, has tried to galvanize the ADB Board to ensure better oversight, we believe that the Board has failed to get management to adequately carry out its fiduciary duties. One of the most important things the U.S. could do to create incentives for the Board to improve its own focus and that of management, would be to promote the improved information disclosure measures mentioned above, especially the full and timely disclosure of all Board proceedings and transcripts.

F. Changes in the Debarment Process

In the July 21, 2004 hearing before this Committee, Treasury Undersecretary John Taylor made two recommendations regarding debarment of corrupt companies which we strongly endorse. First is the automatic publication of debarred companies in the ADB and other MDBs. There is simply no good excuse for the ADB practice (we believe this is true in the IDB also) of keeping the names of debarred companies and individuals anonymous. In the words of Richard Thornburgh and his associates:

> *"The greatest proponents of public disclosure are* [World] *Bank employees with field experience involving procurement issues…they favor as widespread a dissemination as possible…As noted by another* [Bank staffer] *lecturing by the Bank against corruption will not work by itself; "fear must be placed in the hearts" of those willing to give or take a bribe. One of the few things that can provoke such fear is the prospect of a public debarment."*[60]

The second recommendation is cross-debarment from all the MDBs when a company has been debarred from one of them. It would be entirely illogical, and counter-productive, for one MDB to go to the cost and effort of an investigation resulting in the debarment of a company for corruption, while the same company would still be able to do business with its sister institutions—indeed, in some cases, sister institutions working in the same region or country. Moreover, public cross-debarment would have a still more leveraged deterrence effect for other potential bribers and bribees.

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[58] Stephen Baker, "ADB—Wherefore art thou? (reflections of a board member who spent 3 interesting years with the Bank), February, 2001, p. 1.

[59] Frank Black, departing Executive Director for Austria, Germany, Turkey and the United Kingdom, ADB, "The Asian Development Bank (ADB): A Unique Contribution? The Effectiveness of the Financing and Political Role of the ADB in Reducing Poverty in The Asia/Pacific Region," June, 2003, p. 8.

[60] Dick Thornburgh, Ronald L. Gainer, Cuyler H. Walker, "Report Concerning the Debarment Processes at the World Bank," August 14, 2002, pp. 82-83.

If the company is a U.S. one, it should also be debarred from doing business with other U.S. agencies operating abroad, including U.S.AID, the U.S. Export-Import Bank, and the Overseas Private Investment Corporation. Through the OECD Development Assistance Committee (DAC) and the OECD Working Group on Export Credits, the U.S. should also seek similar cross-debarment commitments for the bilateral aid agencies and export credit agencies of other donor nations.

F. Greater Readiness to Halt Loan Disbursements When Government Borrowers Are not Addressing Corruption.

As noted earlier, this is one of the strongest signals the ADB can send that it is serious about corruption. One occasionally hears concerns that slowing lending and halting disbursements for whatever reason will have a negative development impact, since it may increase the number of governments that are paying more money back to the ADB than they are receiving in new loan disbursements. But lending more to indebted governments of poor countries when substantial percentages of loans are being diverted is unconscionable, saddling nations with a debt that is increasingly viewed as illegitimate. It is also a violation of the most basic fiduciary duty in the ADB's charter; namely, to ensure loans are used for the purposes intended.

G. Strengthening the Anti-Corruption Unit

We noted that the ADB Anti-Corruption Unit is much smaller in proportion to the Asian Development Bank than the Department of Institutional Integrity (INT) is to the World Bank. In coordination with other ADB Board members, the U.S. should call for an increase in staffing and resources for the Anti-Corruption Unit, so that its resources are least proportionally closer to those of INT in the World Bank. This would probably mean, for example, an increase of staff size from five to around fourteen.

The Anti-Corruption Unit should be no longer hindered from undertaking anti-corruption investigations, whether in response to a complaint or proactively, in cases where there may be ongoing Inspection Panel investigations or in-country government corruption investigations.

The Anti-Corruption Unit should be given more resources to conduct more numerous and frequent proactive spot corruption and procurement investigations, something which it did for the first time last year in Sri Lanka and is currently planning in Viet Nam.

H. Proactive, Independent Forensic Audits of Corruption for the Thailand Samut Prakarn and Sri Lanka Southern Transport Development Projects.

The ADB's failure to investigate the blatant evidence of corruption and procurement irregularities in the Thailand Samut Prakarn Wastewater Treatment Plant and Sir Lanka Southern Transport Development Project is particularly disturbing. No one appears to be held accountable in the ADB for the blatant mismanagement of these projects, nor does the institution appear to have learned much from the corruption aspects of these cases, since the ADB itself has not conducted a thorough corruption investigation in either instance. We would recommend that the

Committee call upon Treasury to request ADB management to commission independent corruption investigations of these projects, whether through the Anti-Corruption Unit or outside consultants. We believe that the lessons learned would greatly inform wider range efforts to change staff incentives vis a vis corruption, and prevent such abuses from occurring in the future.

It is also imperative that ADB management find some means of delivering restitution and assistance for the communities that have been adversely affected by the mismanagement of these two projects. The affected communities in these two ADB projects are truly “corruption refugees.”