ODA Definition - How does the concept of concessionality apply to private-sector instruments?

DAC Informal meeting on ODA modernisation of private-sector instruments

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Contacts:
Julia Benn, DCD/SDF - Tel: +33(0)1 45 24 90 39 - Email: julia.benn@oecd.org
Valérie Gaveau, DCD/SDF - Tel: +33(0)1 45 24 90 53 - Email: valerie.gaveau@oecd.org

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ODA Definition – How Does the Concept of Concessionality Apply to Private-Sector Instruments?

I. “Concessional in character” is a key criterion of the ODA definition

1. This section invites members’ thoughts on the compliance of private-sector instruments with the ODA definition and its concessionality criterion.

2. The ODA concept relies on two eligibility criteria whereby activities need to be 1) developmental and 2) “concessional in character”. Only concessional activities count as ODA, and while the ODA modernisation process has led to the agreement to change the measurement method for loans (from cash flows to grant equivalents), the concessionality requirement has been maintained through the application of minimum concessional thresholds i.e. only loans conveying grant elements above agreed thresholds will have their grant equivalents recorded as ODA.1

3. To be recorded as ODA, private-sector instruments need to comply with the concessionality criterion too. However, it seems to be a widely accepted principle that private-sector instruments should generally not be concessional in order not to distort the markets. DFIs (and MDBs) have agreed that concessional finance should be provided only in exceptional circumstances, as described in the DFI Guidance for Using Investment Concessional Finance in Private Sector Operations (hereafter referred to as “the DFI Guidance”):

“[…] the major principle of providing finance to the private sector on market-based, non-concessional and sustainable terms. This is because it was acknowledged that subsidised financing to the private sector risks distorting the market and possibly undermining the demonstration impact of any DFI private sector operations. It is for this reason that providing finance to the private sector at concessional terms is not permitted according to the mandates of many IFIs and bilateral agencies, or only permitted in specific cases as an exception to the general rule, which underscores the principle of creating sustainable markets.

For sovereign loans, the 2014 HLM agreed on a quantitative definition of concessionality in character which is differentiated by income group: to be considered concessional and count as ODA, loans have to convey a grant element of 45% for LDCs (calculated at a 9% discount rate), 15% for LMICs (7% discount rate) and 10% for UMICs (6% discount rate). It has since then been clarified that the HLM agreement should apply similarly to loans to official non-sovereign entities (e.g. municipalities, state-owned enterprises), while (in addition to lending to the private sector) the treatment of loans to multilateral organisations remains to be discussed.
Nonetheless, there are instances where subsidies or concessionality may be justified to foster projects with a high development impact through private sector operations. As defined and discussed below, concessional finance for a private sector project may come into play where there are market and/or institutional failures, such as un-priced externalities. In these instances, concessional finance can bridge the immediate gap and support a transition to a sustainable solution. Concessional finance can also address selected distributional concerns by enhancing the equality of opportunity for specific vulnerable groups.” (See [http://www.ebrd.com/downloads/news/roundtable.pdf](http://www.ebrd.com/downloads/news/roundtable.pdf), page 2.)

4. Given the generally non-concessional nature of private-sector instruments, two options seem to be offered to include the effort in using these instruments in ODA:

- Only include in ODA the concessional transactions justified in exceptional circumstances. This would be in line with the definition of ODA, and would send a strong signal in terms of credibility of the measure; by contrast, complementary ways to incentivise this type of instruments should be found, such as a better valorisation of non-concessional developmental flows in the statistical system (e.g. through TOSSD).

- Include in ODA, on a grant equivalent basis, all private-sector instruments, whatever the level of concessionality. The inclusion of non-concessional instruments in ODA would however imply a change in the ODA concept. The 2014 HLM also reconfirmed the principle of minimum concessionality thresholds as a requirement for ODA eligibility and agreed that “alongside reporting on a grant equivalent basis, ODA figures will continue to be calculated, reported and published on the previous cash-flow system”. The application of the decision to publish ODA both on a grant equivalent and cash-flow bases raises challenges in the case of non-concessional private-sector instruments, as these could not credibly be presented as ODA flows.

**Question 1:** Is there common understanding that only concessional instruments should count as ODA? Would removing the concessionality criterion from the ODA eligibility assessment of private-sector instruments blur the ODA concept and endanger its credibility? How to address these challenges?

**II. The assessment of concessionality of private-sector instruments should ensure statistical consistency and integrity**

5. *This section seeks members’ views on consistent, credible and pragmatic options for assessing the concessionality of private-sector instruments (loans, equities, guarantees).*

6. Although it is important to preserve the key foundations of the ODA concept (including the concessionality criterion), it is also critical to reflect the decisions taken so far in the ODA modernisation process. In particular, modernised ODA acknowledges risk in the assessment of concessionality and that risk-taking has a cost, which should be taken into account when measuring the donor effort. The measurement and quantification of concessionality raise different challenges for different instruments, as previously explored in DCD/DAC/STAT(2013)3:

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2 The grant equivalent of a loan is recorded in ODA only if the loan conveys a minimum grant element.
II.1. Loans

7. The DFI Guidance describes the concessionality of loans as follows:

“In its broadest meaning, concessional finance comprises financial products, including loans, guarantees, and equity investments, provided on terms that are clearly more favourable than those explicitly available from the market. [...] Concessionality is achieved either through interest rates below those available on the market, the impact of which can be further enhanced through a favourable, tenor or repayment profile. Other aspects of structure may also make a loan concessional. For example, unless it is reflected in the pricing, lower seniority or a weaker security package of a loan would be considered concessional if commercial financial institutions would normally not accept it for a particular client in a particular market environment. When finance is provided where there is otherwise no access to market (i.e. the market rate is infinite), one could argue that such finance is implicitly concessional. However, we take a more narrow interpretation here.”

8. The above definition could not be operationalised in DAC statistics, as it relies on an individual assessment of local market conditions. The reporting would need to rely on members’ own and complex assessment, based on the specifications of the loan and market conditions. It would also have the disadvantage of lacking transparency (the Secretariat would not be able to verify the concessionality of loans reported as ODA nor to answer data users’ possible related requests), and of not producing necessarily comparable results (if different standards were used by different donors). It would thus be prone to criticism by the public.

9. A possible way forward to develop a quantitative definition of concessionality for loans to the private sector would be to use the same definition as for bilateral lending to official entities.

- Acknowledging that corporate risk is relatively small in proportion to country risk, the system of risk-adjusted discount rates established for official lending could be applied to lending to the private sector, as a proxy. [See DCD/DAC/STAT(2015)3, paragraphs 44-48.] Some members have argued that corporate risk is higher than country risk, but there is no pragmatic way to verify this on a case-by-case basis.

- As regards the thresholds, some members have suggested they be omitted, others have suggested they be decreased, yet others that they need to be maintained. As detailed in Section I, omitting the thresholds would introduce a fundamental change in the ODA definition, and would blur the concept by allowing non-concessional instruments in the measure. Decreasing the thresholds would weaken the notion of concessionality, and complicate the system (two different sets of thresholds for official and private borrowers) for little added value in terms of additional ODA.

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3 Extract from DFI Guidance: “It is acknowledged that concretely assessing, in practice, the level of “the” market rate is often challenging, particularly in less developed economies, where local capital markets are typically underdeveloped or non-existent and borrowers may only have limited and sporadic access to international capital markets or commercial bank lending, if at all. More generally, when competition is limited and markets are illiquid, price signals may not provide a reliable benchmark, making it more difficult to assess the extent to which concessionality is built into a given product. On the other hand, the presence of a concessional element is easiest to identify when it results from explicit blending.”

4 There is no indication in the current Reporting Directives or the December 2014 HLM agreement that the treatment of loans to the private sector should differ from the treatment of loans to the official sector.

5 Noting however that DFIs will determine risk by looking at individual country ratings while the HLM approach is based on a differentiation by country income groups.
recorded. (As private-sector instruments are generally non-concessional, they can only generate small amounts of ODA whatever the thresholds.) It thus seems appropriate to maintain the minimum concessionality thresholds, as agreed at the 2014 HLM, for the grant equivalent of a loan to be recorded as ODA. The need to limit concessionality when providing loans to the private sector would need to be safeguarded through other means than the ODA definition, e.g. through the application of principles such as the ones developed in the DFI Guidance (see question 7).

**Question 2:** For the sake of consistency, credibility and pragmatism, could the quantitative definition of concessionality agreed for official loans at the HLM 2014 be also applied to loans to the private sector? (The same risk-adjusted discount rates and concessionality thresholds would be considered for use as proxies for assessing the concessionality loans to the private sector.)

**II.2. Equities**

10. The DFI Guidance gives an interpretation of what concessionality means for equities:

   “In the case of equity investments, the typical benchmark would be the return required by a commercial equity investor for an investment with similar risk profile.”

11. Main characteristics of elements contributing to the concessionality of equities are not known ex ante (e.g. return, maturity), and providers calculate their expected losses on a case-by-case basis through an informed estimation. As for loans, it seems difficult to make the DAC statistical system rely on such estimates, as the Secretariat would not be able to verify the information provided. On the other hand, setting a uniform quantitative test for the assessment of concessionality of equities would involve the use of several quite crude assumptions [see proposals in DCD/DAC/STAT(2015)3, paragraphs 59-65, e.g. maturity = 8 to 10 years and zero interest rate]. Some members have commented on the over simplification of such assumptions (seen as “hypothetical” and “artificial”) which lacked credibility.

12. In the absence of a quantitative test for assessing their concessionality in character, most members report equity investments as ODA in the DAC statistical system [see DCD/DAC(2015)27, paragraph 7].

13. Instead of developing a quantitative test, other criteria could be used to assess the concessionality of equities. Such criteria have already been developed for structured funds:

   - **Contributions to investment funds in form of first-loss shares are deemed ODA-eligible** (as long as the funds have a developmental purpose and are targeted to ODA recipient countries). An investment without expectation of a return represents a sunk cost and as such can be assimilated to a capital subscription in an international financial institution. This qualitative criterion could possibly apply to the capitalisation of DFIs, under the institutional approach [see DCD/DAC(2015)28, question 3].

   - **Investments in the mezzanine and senior shares** are made on commercial terms and therefore do not qualify as ODA (regardless of their developmental aims).
14. However, the pure ranking of tranches in structured funds is not necessarily always meaningful, as there are first-loss shares provided by the management company as initial “buy-in”, with the mezzanine tranche being the real risk cushion, provided with the objective to mobilise private finance.

15. For flat funds and direct equity, there is no guidance at present. Additional operational criteria would need to be developed for these cases. For example the requirement to reinvest earnings could be seen as a clear signal of concessionality.

16. As concessionality of equities cannot be easily quantified in a way that would sustain public scrutiny, it does not seem practicable to calculate grant equivalents either. Nevertheless, in order to valorise the use of equities and their positive development impact through a recognition of the provider’s effort in ODA, their recording as cash flows in the headline ODA figure, instead of grant equivalents, may be justified, if perverse incentives embedded in the current cash-flow system can be removed. Such a system could work as follows:

- recording, as positive ODA, new concessional equity investment with a development purpose (concessionality would be defined through objective criteria, still to be defined, as suggested above).

- recording, as negative ODA, the proceeds from the sale of equity investments originally reported as ODA, but capping the reflows at the level of the original amount invested, so that the overall net ODA resulting from an equity cannot be negative. That would recognise that equities entail a level of risk, and would avoid penalising the providers.

- collecting data on dividends. Although dividends are not deducted from ODA, their collection could improve transparency and trust in the system, and would align practices across instruments (interests on loans are already collected).

Question 3: What operational criteria could apply to the assessment of concessionality of equities, in particular for investment in flat funds or direct equity? Could the requirement to reinvest earnings be one of these criteria, or could this have negative incentives?

Question 4: The ODA measurement system for loans is based on a cash flow basis but there are serious constraints in calculating credible grant equivalents for equities. Should the alternative of measuring equities on a cash flow basis be considered? Would there be challenges (e.g. in terms of consistency with the rest of the measurement system)? What other alternatives are there?

II.3. Guarantees

17. Guarantees for development are not recorded in the present cash-flow based system, but their grant equivalents could be recorded in the modernised ODA system, acknowledging the cost associated with risk taken in providing this service. The flow itself would still not be recorded as an ODA flow, but as an “amount mobilised”, and possibly reflected under TOSSD. There are several elements that need to be determined for calculating a grant equivalent for a guarantee:

6. The Secretariat understands that decisions to reinvest or not are taken at the institutional rather than instrument level.
Minimum concessionality thresholds

18. It could be argued that it is less critical to apply minimum thresholds for guarantees. The grant equivalent of guarantees would count as ODA (grant equivalent basis, amounts are expected to be relatively small) but no amount would be recorded in the ODA flow series, whatever the threshold. Guarantees could be considered “concessional in character” as soon as they convey a positive grant equivalent.

The grant equivalent could be defined as measuring the concession made by the provider in applying a guarantee fee below the market fee.

19. The “Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees” describes such a methodology. EU member states seem to have applied the method internally, e.g. Italy explains that “The method relies on establishing a theoretical market premium and compares this with the premium actually charged to establish the grant equivalent of the guarantee. The theoretical market premium is determined so that it covers the probability of losses net of recovery, the (adequate) remuneration of capital and administrative costs. […] The differences between the theoretical market premium and the premium actually paid at the end of each period are discounted to their present value using the reference rate.”

20. In practice, given the variety of situations, it would be difficult to establish a unique benchmark for the market fee, and determine the appropriate discount rate to calculate the present value of future premia paid.

21. In DCD/DAC/STAT(2015)3 (paragraphs 51-58 and Tables 5 and 6), it is proposed to calculate the grant equivalent of a guarantee as for a loan, considering the annual premium asked by the guarantor as the “interest rate” for the guarantee, and the amount guaranteed (exposure) as the “principal amount”. Risk-adjusted discount rates would be used, deducting the funding cost (5%) to reflect that guarantees are unfunded instruments, and adding administrative costs (1%).

The grant equivalent could also feature the cost of provisioning for risk.

22. France earlier proposed to apply a coefficient to the exposure and record the result in ODA, see DCD/DAC/STAT/A(2003)1/RD3. The coefficient could be derived from “(i) a calculation of the average provision in respect of this type of assistance; or (ii) a calculation based on banking regulations in the realm of risk ratios (allotment of capital); or (iii) probability calculations.” However it is recognised that, “given the diversity of situations prevailing amongst donors, it would be very tricky to establish a simple rule on this basis.” The paper thus suggests using a fixed coefficient instead (20%).

Question 5: What methodology is appropriate for measuring the grant equivalent of a guarantee (comparing actual premia and market price, recognising cost of provisioning)? Can members suggest methodologies and share information and lessons learnt on methodologies they have used in other contexts (EC Treaty, Articles 87 and 88)?

Question 6: Should minimum concessionality thresholds apply to guarantees?

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7  http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC0620(02)&from=EN
Question 7, applicable to all private-sector instruments:

Would members agree that safeguards to limit concessionality in private-sector instruments be established through principles, such as the ones described in the DFI Guidance? Do stakeholders other than DFIs also subscribe to the principle that private-sector instruments should generally not be concessional, in order not to distort the market, and concessionality should be used only in exceptional circumstances? Do stakeholders subscribe to the core principles described in the DFI Guidance that guide engagement with and support of the private sector [additionality, crowding in, commercial sustainability, reinforcing markets and promoting high standards] and their application to concessional finance? Can a reference to these principles be made in the Reporting Directives?

III. Examples of equity, debt and guarantees

23. To facilitate the discussions on the issues raised above, members will be invited to bring to the meeting examples of concessional and non-concessional equity, debt and guarantees their DFIs have extended to the private sector. The Secretariat will present examples of questions on concessionality of private-sector instruments that it has received from members.