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## DAC Working Party on Development Finance Statistics

# POSSIBLE UPDATE TO CLASSIFICATION BY TYPES OF FINANCE: REVISED PROPOSAL

**19-20 November 2013, Paris**

*This note follows discussions at the June 2013 WP-STAT workshop with DFIs and IFIs on possible updates to the DAC statistical classification by types of finance. It invites discussion on the broad categories of the proposed new list by financial instruments and presents revised subcategories for members' comments. It also discusses what further work is needed to implement such a revision in the DAC statistical system.*

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**English - Or. English**

**POSSIBLE UPDATE TO CLASSIFICATION BY TYPES OF FINANCE
REVISED PROPOSAL**

## I. Introduction

1. This note follows discussions at the June 2013 WP-STAT workshop with DFIs and IFIs on possible updates to the DAC statistical classification by types of finance. Participants welcomed the initial suggestions to develop an improved list of financial instruments to facilitate data collection but also to raise awareness of DFIs' and IFIs' operations in developing countries.[1] In particular, they noted that identifying different levels of risk-taking in the classification would be one concrete way to enhance the current DAC statistical framework and also to increase incentives for reporting DFIs' and IFIs' operations in DAC statistics. Moreover, they supported the general structure of the list of financial instruments and encouraged the Secretariat to work further on the sub-categories (e.g. draft definitions, remove possible overlaps, assess optimal level of granularity).

2. The present note elaborates suggestions for discussion at the WP-STAT informal meeting scheduled on 20 November 2013 as follows.

- Section II invites discussion on the **broad categories of financial instruments**, including their definitions.
- Section III presents the **list of financial instruments**, highlighting modifications made to it to take into account comments received during the Workshop and subsequent bilateral consultations. It also contains **"technical fiches"** covering the new instruments proposed, with information on their functioning and characteristics, examined from both provider and recipient perspectives.
- Section IV looks at **what additional work would be needed to incorporate the classification by financial instruments in the reporting system**. It invites members to consider both the continuity in existing DAC statistical series and the need to modernise the measurement system to improve the coverage of market-like operations and better capture the full spectrum of resource flows from the perspective of the recipients.

3. **Members are invited to comment on the proposed categories and sub-categories of financial instruments.** The Secretariat will pursue the work on the technical fiches and definitions in the coming months, with the objective of presenting a complete proposal for members' consideration at the 2014 formal meeting of the WP-STAT.

4. The WP-STAT work on types of financial instruments also contributes to the implementation of the work plan for DAC HLM mandate on modernising the measurement and monitoring of external development finance post 2015. In particular, it is relevant to the "stocktaking and mapping of providers of development finance and their financial products" [see DCD/DAC/RD(2013)13/RD4, objective 2A].

1 . Cf. DCD/DAC/STAT(2013)6 and DCD/DAC/STAT(2013)15, paragraphs 2-4.

## II. Definition of the broad categories of instruments

5. Based on positive feedback on the overall structure of the proposed classification at the June 2013 Workshop, this section presents initial suggestions for definitions of the four broad categories of financial instruments: grants, debt instruments, equity and investment fund shares, and other financial instruments. It is recalled that the structure of the proposed list follows the rationale for classifying financial instruments in the balance of payments. Table 1 below therefore shows for reference the existing definitions from the DAC statistical system and the Sixth Edition of the Balance-of-Payments Manual (BPM6), slightly adjusted for the purpose of DAC statistics. **Members' comments are invited.**

**Table 1. Broad categories of financial instruments**

| Main category of instruments | Definition |
|---|---|
| **Grants** | ***Grants*** are transfers in cash or in kind for which no legal debt is incurred by the recipient. ***Capital subscriptions*** to multilateral agencies are for most purposes assimilated to grants in DAC statistics.<br><br>*Sources: DAC converged reporting directives (Chapter 1, para. 23-24)* |
| **Debt instruments** | ***Debt instruments*** require the payment of principal and/or interest at some point(s) in the future according to a predefined formula, limiting the creditor's risk exposure. Debt instruments can take the form of loans and debt securities:<br>- *Loans* are financial assets that i) are created when a creditor lends funds directly to a debtor, and ii) are evidenced by documents that are not negotiable.<br>- *Debt securities* are negotiable instruments serving as evidence of a debt. They include bills, bonds, notes, negotiable certificates of deposit, commercial paper, debentures, asset-backed securities, money market instruments, and similar instruments normally traded in the financial markets.<br><br>*Sources: BPM6, paragraphs 5.31, 5.44, 5.51.* |
| **Equity and investment fund shares** | ***Equity and investment fund shares*** have the distinguishing feature that the holders own a residual claim on the assets of the institutional unit that issued the instrument.<br>- *Equity* represents the owners' funds in the institutional unit. [In contrast to debt, equity does not generally provide the owner with a right to predetermined returns or returns determined according to a fixed formula.]<br>- *Investment fund shares* have a specialised role in financial intermediation and refer to collective investment in other assets.<br><br>*Sources: BPM6, paragraphs 5.19, 5.20, 5.21.* |
| **Other securities** | ***Other securities*** include the residual instrument category "Other financial assets and liabilities" of BPM6 (e.g. derivatives). |
| **Guarantees**[1] | A ***guarantee*** is defined as a legally binding agreement under which the guarantor agrees to pay part or the entire amount due on a loan, equity or other instrument in the event of non-payment by the obligor or loss of value in case of investment.<br><br>*Sources: Survey on Guarantees for Development* |

1. Guarantees are not covered in DAC statistics at present, but options for separate data collection have been developed. See DCD/DAC/STAT(2013)17.

## III. Sub-categories of financial instruments

### A. Changes from the initial proposal

6. At the June workshop, participants suggested that further work should be done to i) assess whether the separate identification of all financial instruments listed in DCD/DAC/STAT(2013)6 was actually needed, and ii) remove potential overlaps between sub-categories. Some members also suggested that the types of finance should facilitate the flow categorisation between ODA and non-ODA and expressed concern that this would no longer be the case with more generic financial instruments.

7. A revised version of the list of financial instruments is presented in Table 2 below. It contains the following changes from the June version:

- **The "syndicated loan" item has been removed** to avoid overlaps with other loans.[2]
- **The sub-categories relating to mezzanine finance have been clarified**. The classification has been adjusted to clearly distinguish between **"subordinated loan",** including loan component of mezzanine finance, under the loan category, and **"preferred equity",** including equity component of mezzanine finance, under the equity category.
- **The two former categories "equity investment" and "investment fund shares" have been merged**. First-loss shares in structured capital investment funds are separately identified to facilitate reporting on these investments that in the current system may qualify as ODA[3].
- Three additional columns have been included to indicate the possible level of detail available for reporting on financial instrument. Marking in the "official flows" column should not be taken to indicate the ODA-eligibility or non-eligibility of a particular instrument.

### B. Technical fiches

8. The Secretariat has prepared technical fiches to describe the functioning of the instruments proposed to be added in the list and invite reflection on their pertinence for DAC analyses of broader development finance (see pages 9 to 18).[4] The fiches are all structured in the same fashion and aim to provide the following information:

- Detailed description of the instrument, its functioning and why it is important to separately identify it in the development finance context;
- Commentary on the instrument from the provider and recipient perspectives;
- Commentary on the capacity of the instrument to mobilise private investment;
- Institutions known to be using the instrument at present.

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2. Syndicated loans are gaining importance in IFIs' portfolios and contribute to mobilising important volumes of private funding for development (e.g. IFC's A and B loans programme). The Secretariat will explore options to measure funds mobilised by syndicated loans and other specific financial instruments (e.g. investment in investment funds, mezzanine finance) as part of the work on leveraging.

3. See also WP-STAT agreement on the ODA eligibility of first-loss shares to developmental investment funds [DCD/DAC/STAT/M(2012)2/REV2, paragraph 7].

4. As part of work on post-2015 measurement of development finance, similar fiches will be prepared on broader financial mechanisms, e.g. innovative financing for development.

9. **Members are invited to i) give their feedback on the revised list and whether it better reflects and facilitates reporting on development finance beyond ODA and ii) review the technical fiches.**

**Table 2. Possible new list of financial instruments**

| Heading | Name | OFFICIAL FLOWS (e.g. aid agencies, DFIs) | PRIVATE FLOWS from NGOs and foundations | PRIVATE FLOWS market-based[1] |
|---|---|---|---|---|
| GRANTS | **Grants** | | | |
| | Standard grant | X | X | X |
| | Interest subsidy | X | | |
| | **Capital subscriptions** | | | |
| | Capital subscription on deposit basis | X | | |
| | Capital subscription on encashment basis | X | | |
| DEBT INSTRUMENTS | **Loans** | | | |
| | Standard loan | X | X | X |
| | Subordinated loan, incl. loan component of mezzanine finance (NEW) | X | X | |
| | Blended loan (NEW) | X | | |
| | Reimbursable grant (NEW) | X | | |
| | **Debt securities** | | | |
| | Conventional bonds | X | X | |
| | Asset-backed securities (NEW) | X | | |
| | Other debt securities | X | | X |
| EQUITY AND INVESTMENT SHARES | **Equity and investment fund shares** | | | |
| | Common equity (NEW) | X | X | X |
| | Preferred equity, incl. equity component of mezzanine finance (NEW) | X | X | |
| | First-loss shares in structured investment fund (NEW) | X | X | |
| | Other investment fund shares (NEW) | X | X | |
| | Reinvested earnings | X | X | X |
| OTHER SECURITIES | Other (including financial derivatives) | | | X |
| GUARANTEES | **Guarantees** (collected separately) | | | |
| | Loan guarantee | X | | |
| | Equity guarantee | X | | |
| | Other guarantee | X | | |

[1] Apart from expenditures by Foundations and NGOs, data on private flows are collected at the aggregate or semi-aggregate level. Consequently, it is likely that only the most general financial instrument subcategory would be used.

## IV. Further work needed

10. This section aims to highlight areas where further work would be needed if a new/revised classification by financial instrument were to be introduced in the DAC system. Discussion is invited on:

- how best to facilitate the inclusion of a new classification by financial instrument in the current statistical framework;
- whether the costs of updating the classification are justified by the expected improvements in data quality and quantity; and
- whether this update should be accompanied with a broader reflection on the functional categories for non-ODA flows (i.e. FDI), either through a separate classification or by expanding the current list of modalities (types of aid).

### A. Integration of the new financial instrument list in the DAC system

11. The current type of finance classification captures information which is not necessarily related to financial instruments but rather serves to derive the DAC1 aggregates on non-ODA flows. For example, "subsidies to national investors" or "loans to national private investors" identify transactions that by definition are reportable as OOF and which therefore need to be subtracted from the private flows they support in order to arrive at the net flow from the private sector. Integration of the new financial instruments classification in the reporting system would thus require defining the method of identifying these DAC1 aggregates in CRS data with the help of other variables. Alternatively, data on the financial instruments could be collected in a new (additional) data field. The pros and cons of the two possible methods could be summarised as follows:

- ***Financial instruments as a new and additional dimension*** would allow members to maintain their current methodologies for calculating the ODA vs. non-ODA aggregates, but would increase the incidence of overlaps between classifications and duplication between dimensions (i.e. category of flow, type of finance, type of instrument, etc.).
- ***Financial instruments as a substitute for types of finance*** has the advantage of limiting the proliferation of reporting items in the system as well as potential overlaps. However, to ensure continuity of the DAC statistical series with regard to type of finance and also to facilitate the conversion of historical series, a mapping would be needed between the current list by type of finance and the new list of financial instruments, making use of other CRS dimensions.

12. The Secretariat has tested the second method, which appears feasible. It would however require clearer identification of the financing modalities and the creation of a number of new "channel of delivery" codes pertaining to private sector institutions (see Table 3).[5] As regards the latter, there are frequent requests for data on support to sovereign vs. non-sovereign[6] recipient institutions. The current system does not make this distinction but proposals could be developed as part of the mapping exercise.

13. **Members are invited to discuss both methods and the possible need to further elaborate the channels of delivery under category 50000 ("other").**

### B. Expected benefits of updating the list of types of finance vs. implementation costs

14. The proposed update of the types of finance classification, and in particular its refocusing on financial instruments, should result in clearer reporting instructions and improved data quality.[7] However, any modification of the reporting system involves costs in terms of database management, training staff in agencies to apply the new classification and modifying statistical publications. In the experience of the

5 . The rationale of the current classification overlaps with other classifications (e.g. the "aid loan" type of finance also reflects the category of flow - ODA) and mixes financial instruments with other dimensions such as type of institution providing or benefiting from the funds [for more information, see DCD/DAC/STAT(2013)6, Annex 1].

6 . Public sector institutions can be sovereign or non-sovereign. Sovereign institutions include general government sector and all public corporations, including the central bank, while non-sovereign institutions include municipalities or firms controlled by the government but which do not carry its "full faith and credit" or whose obligations are not guaranteed by the government.

7 . During discussions on the Converged Reporting Directives, members noted the need to update and clarify the types of finance classification and it was agreed that clarifications be elaborated in the context of the non-ODA workstream. See DCD/DAC/STAT(2012)2, Point 5- Financial instruments (types of finance).

Secretariat, implementation of a new classification takes 2-3 years. For these reasons, before elaborating any final proposal, **the Secretariat invites members' comments on a number of cost-benefit questions**:

- Will members be able to obtain sufficient reporting on the new instruments to justify introducing the new sub-categories?
- Will members be able to obtain activity-level reporting from their DFIs on the use of the instruments?
- At which level of detail could the information on market-like financial instruments be published? Are there confidentiality constraints that would limit the possibilities for making the data available at activity level? If yes, could semi-aggregated presentations (by recipient, provider and sector) be envisaged?
- Finally, do the categories cover the full range of DFIs' activities that members feel should be recorded in DAC statistics?

### C. Possible work on modalities beyond ODA

15. As also discussed at the 2013 June Workshop, a number of existing types of finance (e.g. FDI, officially supported export credits) do not relate to a single financial instrument but rather to the BPM6 concept of functional categories[8] which try to capture the type or degree of control that the donor or investor has over the use of the funds. Participants broadly supported the Secretariat analysis and confirmed that more thinking and discussion were needed on whether to develop functional categories for non-ODA flows, and whether these should constitute a separate classification or an extension and adaptation to other flows of the current list of aid modalities.

16. A preliminary assessment suggests that functional categories should be created at least for investment (distinguishing between foreign direct investment and portfolio investment) and export credits (distinguishing between officially supported export credits and other export credits). **This aspect will be further developed in the next iteration of the proposal, linked to the broader DAC work on development finance post-2015.**

17. The revision of the DAC classification by type of finance would constitute an important step towards improving the DAC picture of the development finance landscape. However, it would not necessarily resolve problems that some have highlighted[9] concerning the inability of the flow-based system and ODA criteria to provide incentives to use market-like instruments when appropriate (successful investment being presented as negative flow). These problems may need to be addressed by other means (e.g. through measurement of incentive and mobilisation effects).

8 . BPM6 describes the functional categories as operations implying a particular relationship between the parties and a specific motivation for investment.

9 . February 2012 WP-STAT Workshop with DFIs held in Vienna.

**Table 3. Scope for mapping between the current types of finance and the new list of financial instruments**

| Current reporting | | Possible mapping | |
|---|---|---|---|
| **Current type of finance** | **Applicable flow category[1]** | **Possible new financial instrument** | **Additional information required** |
| 110: Aid grant excluding debt reorganisation | 10/20/30 | Standard grant | |
| 111: Subsidies to national private investors | 20 | Standard grant | New channel code needed to identify **national private investors.** |
| 210: Interest subsidy grant in AF | 10 | Interest subsidy | AF flag=1. |
| 211: Interest subsidy to national private exporters | 20 | Interest subsidy | New channel code needed to identify **national private exporters**. |
| 310: Deposit basis | 10 | Capital subscription on deposit basis | Parent channel code 40000. |
| 311: Encashment basis | 10 | Capital subscription on encashment basis | Parent channel code 40000. |
| 410: Aid loan excluding debt reorganisation | 10 | Standard loan | |
| 411: Investment-related loan to developing countries | 20 | Standard loan | |
| 412: Loan in a joint venture with the recipient | 20 | Standard loan | New channel code/flag needed to identify **joint venture in the recipient country**. |
| 413: Loan to national private investor | 20 | Standard loan | New channel code needed to identify **national private investors.** |
| 414: Loan to national private exporter | 20 | Standard loan | New channel code needed to identify **national private exporters**. |
| 451: Non-banks guaranteed export credits | 20/35 | Standard loan | New functional categories needed for **Export Credits**. |
| 452: Non-banks non-guaranteed portions of guaranteed export credits | 20/35 | Standard loan | New functional categories needed for **Export Credits**. |
| 453: Bank export credits | 20/35 | Standard loan | New functional categories needed for **Export Credits**. |
| 510: Acquisition of equity as part of a joint venture with the recipient | 10/20 | Common equity | New channel code (or flag) needed to identify **joint venture in the recipient country**. |
| 511: Acquisition of equity not part of joint venture in developing countries | 10/20 | Common equity | |
| 512: Other acquisition of equity | 10/20 | Common equity | |
| 710: Foreign direct investment | 35 | Standard loan, common equity or other (in particular if information by instrument is not available) | New functional categories needed **for Investment**. |
| 711: Other foreign direct investment, including reinvested earnings | 35 | Reinvested earnings | New functional categories needed **for Investment**. |
| 810: Bank bonds | 35 | Conventional bonds | New channel code needed to identify **donor country bank**. |
| 811: Non-bank bonds | 35 | Conventional bonds | New channel code needed to identify **other non-bank operations, including national private investors.** |
| 910: Other bank securities/claims | 35 | Other debt securities | New channel code needed to identify **donor country bank**. |
| 911: Other non-bank securities/claims | 35 | Other debt securities | New channel code needed to identify **other non-bank operations, including national private investors.** |
| 912: Securities and other instruments issued by multilateral agencies | 35 | Other debt securities | Parent channel code 40000. |

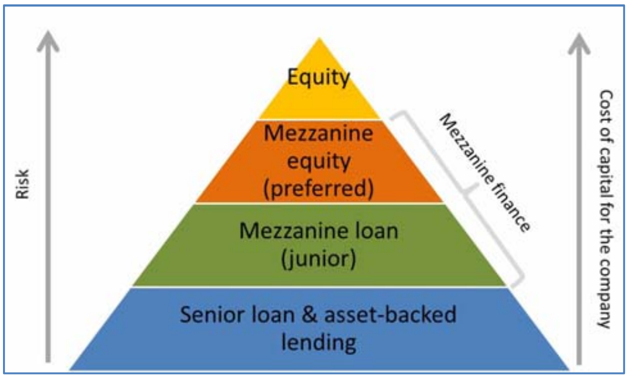
[1]: In CRS++ reporting, private flows (category 35) are reportable at semi-aggregate level (by recipient and main type of finance).

# TECHNICAL FICHES

# OF

# NEW PROPOSED FINANCIAL INSTRUMENTS

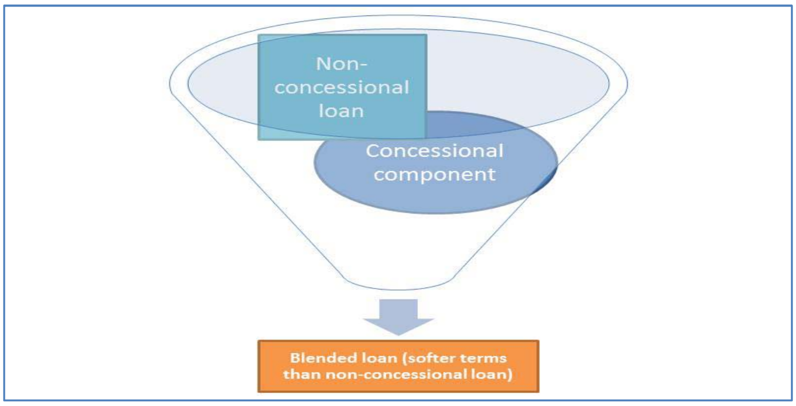
## Mezzanine finance (new subcategories)

| | |
|---|---|
| **Description** | Mezzanine capital refers to the layer of financing between a company's senior debt and equity. It may take the form of subordinated debt or preferred equity. Typically, mezzanine finance includes both.<br><br>A mezzanine loan is a loan that, in the event of default, will only be repaid after all senior obligations have been satisfied. In compensation for the increased risk, mezzanine debt holders require a higher return for their investment than secured or more senior lenders.<br><br>Mezzanine equity is equity that, in the event of default, will be repaid after all senior obligations and mezzanine loans have been satisfied; and will be paid before common equity holders. It is a more expensive source of finance than senior debt, a less expensive source than equity.<br><br>Mezzanine capital is typically used to fund a growth opportunity, such as an acquisition, new product line, and new distribution channel or plant expansion. While additional liquidity can be obtained from equity investors, equity is the most expensive source of capital and an increase of capital may dilute the level of control of existing shareholders. As banks typically place ceilings on the amount of total debt a company can obtain, mezzanine debt can be an attractive alternative way to obtain much needed capital.<br><br><br> |
| **Provider perspective** | • Compared to a senior loan, investment in mezzanine finance implies an additional risk in the event of default, as the mezzanine capital will only be repaid after all senior obligations have been satisfied. The additional risk involved in mezzanine finance operations is compensated by higher returns.<br>• Measurement will differ depending on the instrument used (preferred equity or junior loan), but in any case reflects a cross-border flow. |
| **Recipient perspective** | • When senior debt is not available, mezzanine finance allows access to capital with lower costs than equity. Mezzanine finance is particularly relevant to SMEs which often have limited access to senior debt. |
| **Potential mobilisation of private investment** | • Mezzanine investment by DFIs increases the creditworthiness of the investee companies and creates incentives for other actors (e.g. private banks) to invest in the company. In practical terms, assessing the additionality of private finance mobilised by mezzanine investment (assessing which private resources would not have been available without the mezzanine capital) is not straightforward in an international statistical system. |

| | | |
|---|---|---|
| **Main extending institutions** | **BILATERAL**[Error! Reference source not found.]<br>AUSTRIA - OeEB<br>BELGIUM - BIO<br>EUROPEAN UNION INSTITUTIONS - EIB<br>FINLAND - FINNFUND<br>FRANCE - PROPARCO - AFD<br>GERMANY - DEG<br>ITALY - SIMEST<br>JAPAN - JBIC<br>NETHERLANDS - FMO<br>NORWAY - NORFUND<br>SPAIN - COFIDES<br>SWEDEN - SWEDFUND | **MULTILATERAL**<br>African Development Bank (AfDB)<br>Asian Development Bank (AsDB)<br>Caribbean Development Bank (CDB)<br>European Bank for Reconstruction and Development (EBRD)<br>Inter-American Development Bank (IADB)*<br>International Finance Corporation (IFC)<br>OPEC Fund For International Development (OFID)<br><br>**PRIVATE SECTOR**<br>Commercial banks<br>Sovereign wealth funds<br>Investment funds |

1. Based on the DFIs/IFIs review carried out by the Secretariat in 2012.

## Blended loan (new subcategory)

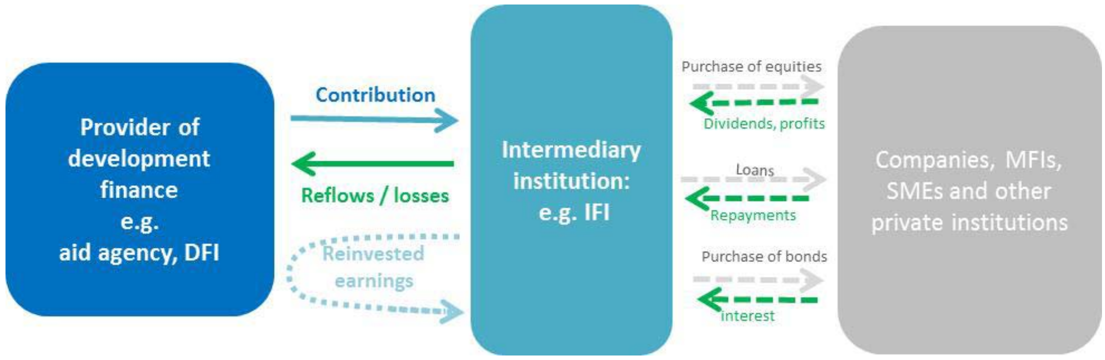
| | |
|---|---|
| **Description** | In private finance, a blended loan refers to the combination of two or more loans into one loan, resulting in a blended interest rate.<br><br>In the context of development finance, blended loan financing refers to the combination of a concessional component (grant or loan) and a non-concessional loan.<br><br>The main objective of blending mechanisms is to soften the terms and conditions (e.g. lower interest rate, longer tenor) of the repackaged loan to meet project finance needs. Blending mechanisms facilitate access to finance for investments in large projects in countries or sectors that have a higher perceived risk level.<br><br> |
| **Provider perspective** | • In current DAC statistics the face value of the loan is reported and blended loans cannot be separately identified. An exception is the associated financing (AF) where interest subsidy is recorded separately (as ODA) from the export credit component (as OOF). |
| **Recipient perspective** | • Enable investments in particular sectors and/or countries that would not otherwise happen given perceived risk levels without blended financing (e.g. because they are not bankable unless the overall cost of capital is reduced). |
| **Potential mobilisation of private investment** | • In the context of development, blended mechanisms mobilise public finance by mixing concessional and non-concessional public resources. Private finance may also be mobilised as the availability of affordable debt finance (blended loan) can help project developers attract private equity finance that underpins the overall finance package. In practice, however, tracking the mobilisation of such private investors is not straightforward and may lead to double-counting, especially for blended mechanisms involving more than one public actor. |
| **Main extending institutions** | **BILATERAL**<br>AFD<br>KfW<br><br>**MULTILATERAL**<br>IFC<br>IADB<br>IBRD/IDA<br><br>**PRIVATE SECTOR** |

## Reimbursable grant (new subcategory)

**Description**

In development finance, a reimbursable grant can be described as a contribution provided to a recipient institution for investment purposes, with the expectation of long-term reflows at conditions specified in the financing agreement. The provider assumes the risk of total or partial failure of the investment; it can also decide if and when to reclaim its investment.

Donor funds are provided to intermediary institutions for investment purposes and, to the extent that money flows back from the investments, principal, interest, dividends, and any other investment reflows may be reinvested or returned to the donors. The institution administering the donor investment funds does not bear any financial risks (it is not financially liable in case of a failure in either equity or loan; donors cover first losses) and is not entitled to any financial benefits (donors provide funds for a period of time; at maturity they may take back the amount in the trust fund or let the intermediary institution use the money for other investments or advisory services).




**Provider perspective**

- Provider funds serve to increase the intermediary institution's capacity to invest in recipients' private sector or cover the first losses. At maturity, they have the possibility to reinvest all the money for new investment programmes or repatriate the funds.
- DAC statistics capture the provider perspective at two points in time: 1) when the reimbursable grant to the intermediary institution (i.e. IFI) is committed and disbursed, and 2) when the institution returns the funds, plus potential profits (or minus potential losses).

**Recipient perspective**

- The intermediary institution uses the funds to soften or expand its financial offer (through blending mechanisms) to support investments in particular sectors of the recipient economy.
- Data on the use of the reimbursable grant for investments (including leveraging) could be collected from multilateral intermediary institutions, although details may be subject to confidentiality constraints.

**Potential mobilisation of private investment**

- Donor funds for investment "crowd in" private investment in specific sectors that would be too risky or not viable at market conditions.

**Main extending institutions**

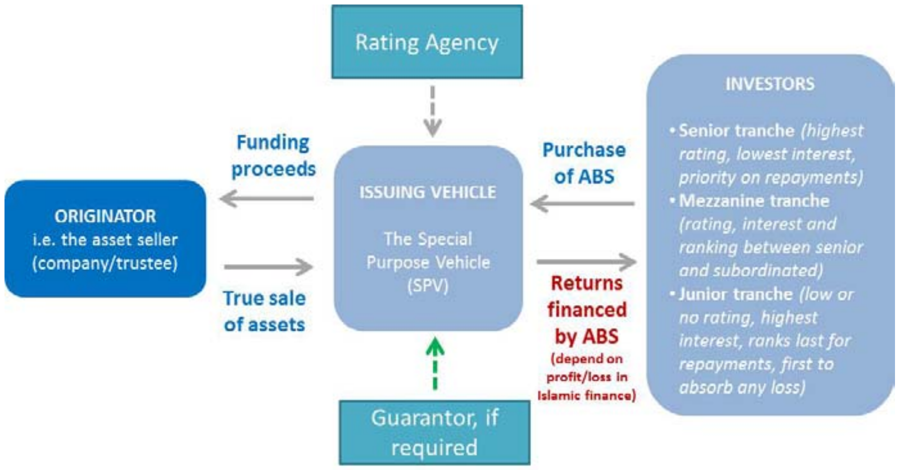
**BILATERAL AGENCIES AND DFIs** (e.g. CIDA)

Reimbursable grants have so far been used to support IFIs' investment programmes (e.g. the IFC Financial Mechanisms for Climate Change - FMCC) but questions on how to report on bilateral vehicles have also been raised.

## Asset-backed securities (new subcategory)

**Description**

Asset-backed securities (ABS) are securities whose value and income payments are derived from and backed by a specific pool of underlying assets. The pool of assets is typically a group of small and illiquid assets which are unable or difficult to be sold individually. Pooling the assets into financial instruments allows them to be sold to investors through a process called “asset securitisation” (see diagram below).




- The original owner of the assets – the “**originator**”, i.e. a company or trustee – sells them to a “special purpose vehicle” (SPV) whose sole function is to buy such assets in order to securitise them.
- **The SPV** creates and sells the securities in the form of asset-backed securities and uses the proceeds of the sale to pay back the bank that created, or originated, the underlying assets.
- The assets are evaluated apart from the credit quality of the originator/seller by **rating agencies**. In some cases, investors may also have recourse to guarantors.
- The SPV is responsible for "bundling" the underlying assets into a specified pool that will fit the risk preferences and other needs of investors (e.g. different class of securities – junior to senior) and for distributing payments which will be based on the underlying assets’ performance.

**In Islamic finance**, most sukuk (i.e. Islamic certificate of investment) are asset-backed to comply with sharia requirements of risk-taking and sharing of profit and losses. For private companies in developing countries, this mechanism has constituted since the financial crisis a more sustainable alternative source of financing to conventional finance. For investors, although asset-backed securities are more risky (if the assets do not generate profit or occur losses, or if they are destroyed or damaged), they are at the same time protected from defaults (they offer investors neither income nor capital guarantees, except if a guarantee mechanism is set up. Issuers pay profits to investors when the underlying assets earn profits).

**Provider perspective**

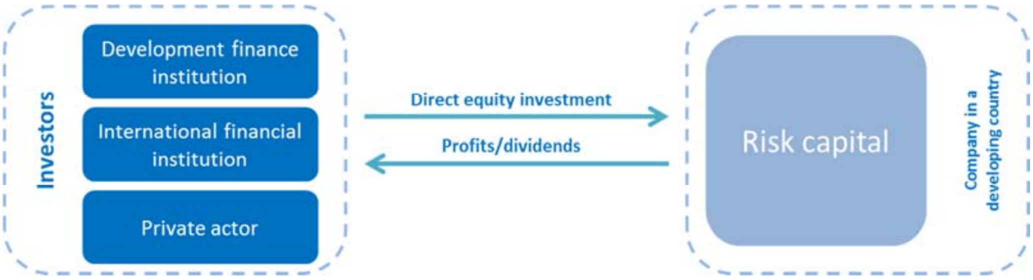
- The issuer (SPV), or the guarantor if any, assumes the risk of default of the underlying assets.
- In DAC statistics, the purchase of bonds is recorded as positive flow to developing countries while return flows of investment income to the purchaser are not recorded.
- In Islamic finance investors take the risk that the asset-backed securities do not generate any profit or even face losses (and subordinated investors in particular if the pool of securities is structured).

| | |
|---|---|
| **Recipient perspective** | Asset-backed securities have the following advantages for the originator (i.e. the recipient):<br>• **they offer lower-cost funding than traditional bank loan or bond financing**. Indeed, the pool of receivables is typically of a better credit quality than that of the originator itself (against whom investors have no recourse if the receivables fail to perform). Without securitisation, the originator would finance itself through borrowing based on its own creditworthiness.<br>• **they allow the originator to remove potentially risky assets from its balance sheet**, thus transferring the default risk associated with those assets to investors and allowing the company to borrow more; and<br>• the true sale of assets to the SPV provides **bankruptcy remoteness** by insulating the assets from the originator;<br>• **they increase borrowers' funding options**.<br>The use of this instrument can be valorised in recipient receipts data only if the investor entity reports the purchase of asset-backed securities at a sufficient level of detail (i.e. by recipient and sector). |
| **Potential mobilisation of private investment** | Asset-backed securities, through the securitisation process, contribute to catalysing investment capacity of private companies with limited access to financial markets by freeing up their balance sheet thus increasing their borrowing capacities. Options to track the amount of private investment mobilised by these instruments could be explored. |
| **Main extending institutions** | **ISLAMIC DEVELOPMENT FINANCE INSTITUTIONS**<br>e.g. Islamic Development Bank<br>**PRIVATE SECTOR**<br>Commercial banks and investment funds |

## Direct equity (new subcategories)

**Description**

Direct equity is a share in the ownership of a corporation that gives the owner claims on the residual value of the corporation after creditors' claims have been met.




*Common equity investment* (also called common stock) refers to investment in flat capital structures and therefore has no particular characteristics in terms of convertibility to other instruments or seniority over other types of equity. Common equity is returned to investors only when they sell their shareholdings or when the assets of the company are liquidated and proceeds distributed among them after satisfying the company's obligations.
By contrast, if the risk capital is composed of instruments with different levels of seniority/subordination:

- *common equity* refers to junior equity, which ranks lower than other forms of equity (i.e. it is subordinated to preferred stock), and
- *preferred equity*, in the event of default, is repaid after all senior obligations and mezzanine loans have been satisfied; and is paid before common equity (see also fiche on mezzanine finance, pages 10-11).

**Provider perspective**

- Common equity capital sits in a first-loss position with respect to any losses and to the business' default. The risk involved in common equity investment is compensated by higher returns.
- In DAC statistics, the financial effort of the investor is measured at the moment of the purchase of equity, while the sale of equities is recorded as a negative flow, as it implies a transfer of money from the developing country back to the investor. Presented on a net basis, successful investments tend to be "penalised". (Dividends are not recorded.)

**Recipient perspective**

- An equity investment represents own capital and provides the business with the capacity of increasing its assets. Direct equity by highly-rated investors (e.g. DFIs, aid agencies) increases the creditworthiness of the investee company in the capital market and its negotiation power with local authorities and other market actors.
- Direct equity represents a bilateral flow, so data on the purchase of equity by investors also capture the flow from the recipient receipts perspective.

**Tracking private investment mobilised**

The increased creditworthiness and risk capital can be strong incentives for other potential investors to finance the business with other risk capital or debt instruments. However, the link between public and private equity investment in companies' capital stock might be difficult to establish and, a fortiori, to track.

**Main extending institutions**

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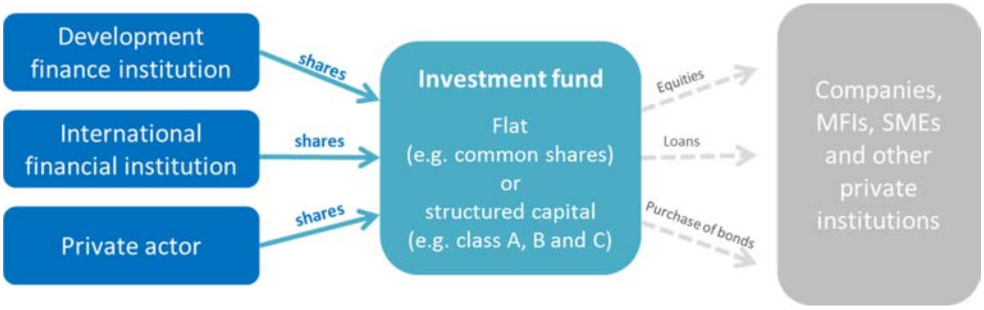
|---|---|
| **BILATERAL** | **PRIVATE SECTOR** |
| Development Finance Institutions | Private DFIs |
| **MULTILATERAL** | Foundations |
| International Financial Institutions | Other private investors |

## Investment fund shares (new subcategories)

**Description**

Investment fund shares or units refer to the shares issued by mutual funds and unit trusts, rather than the shares the latters may hold. Mutual funds are collective investment vehicles through which investors pool funds for investment in financial or nonfinancial assets or both. These funds issue shares (if a corporate structure is used) or units (if a trust structure is used).

Mutual funds are principally classified according to the primary objective (i.e. whether they pursue capital or fixed income gains): there are stock funds, bond funds, sector funds, money market funds and balanced funds.




The risk capital of a mutual fund can either have:

- a flat structure, in which all shares have the same profile with respect to risks, profits and losses (i.e. common shares/units); or
- different share classes or tranches, allowing the creation of different profiles with respect to cost/fee structures, dividend policy, currencies, and minimum investment sums. If the risk capital is divided in tranches with a different level of seniority, **first-loss shares** refers to the most junior “tranches” of capital in structured finance, which bear a higher risk and absorb the first losses, but may also have a higher expected yield.

**Provider perspective**

- Equity investments in mutual funds are risk capital that only has claims on the residual value of the fund after the claims of all creditors and, in case of first-loss shares/units, holders of more senior shares/units have been met.
- One of the main advantages of mutual funds is diversification of the investment. For the investor, it is usually easier, less expensive (lower transaction costs) and more efficient to invest in mutual funds than to buy direct equity in companies.
- DAC statistics record the purchase and sale of investment fund shares issued by PPPs and mutual funds in developing countries. The financial effort (positive flow) and the investment returns (negative flow) of the investor are measured at the moment of the purchase and the sale of investment fund shares respectively. First-loss fund shares bear a higher risk and are therefore more likely to be recorded as positive flows over the investment cycle.

**Recipient perspective**

- Mutual funds pool resources from different sources: for a recipient company, it is therefore easier and cheaper in terms of transaction costs to access a pool of investors rather than looking for individual investors separately.
- The presence in the mutual fund of highly-rated investors (e.g. public sector and DFIs) increases the fund’s capability of financing risky projects.
- Data on the investments made could be collected from multilateral investment funds, although they may be subject to confidentiality constraints.

| | |
|---|---|
| **Potential mobilisation of private investment** | • Mutual funds make investing easier and less expensive for the capital provider. The purchase of first-loss shares by official development institutions attracts and catalyses private funding for developmental projects. |
| **Main extending institutions** | **BILATERAL**<br>Aid agencies<br>Development Finance Institutions<br>**MULTILATERAL**<br>International Financial Institutions<br><br>**PRIVATE SECTOR**<br>Private Development Finance Institutions<br>Foundations<br>Other private investors |