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LOAN CONCESSIONALITY IN DAC STATISTICS

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This note outlines the Secretariat's approach to assessing concessionality of ODA loans. It is circulated for DISCUSSION at the meeting of the DAC scheduled on 20 February 2013.

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LOAN CONCESSIONALITY IN DAC STATISTICS

Purpose

1. This note responds to a request by the DAC Chair at the High Level Meeting breakfast at Carlton House, London, on 5 December 2012. Noting a lack of agreement among DAC members concerning the definition of concessionality, the Chair asked the Secretariat to produce a paper outlining its approach to assessing the concessionality of ODA loans.

Background

2. Loans have always been, and continue to be, an important element in development finance, and concessional loans represent an important part of ODA. Eleven DAC members currently provide concessional loans. Among the non-DAC bilateral and multilateral providers of development finance reporting to the DAC, 15 agencies (five multilateral development banks, seven Arab institutions and three other international financial institutions) extend concessional loans.

3. Non-concessional loans – as provided e.g. by the International Bank for Reconstruction and Development (IBRD) and the other development banks – are similarly an important part of overall development finance, particularly in relation to middle-income countries. Such loans, made from funds raised in the capital markets, use the credit rating of the lending institution to secure attractive terms to developing countries. They enable developing countries to obtain financing on much softer terms than they could normally expect on the market. Nevertheless, such loans have not been reported as concessional loans in DAC statistics. In the terminology used by the IBRD and the other development banks they are referred to as ordinary capital operations and categorised as non-concessional loans. [1]

4. To qualify as ODA, a flow must among other things be "concessional in character"[2]. It must also convey "a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)".[3] When interest rates are low, it is easy to satisfy the grant element test. Whether a loan qualifies as ODA then depends largely on what meaning is assigned to "concessionality in character".

5. The issue of how to establish "concessionality in character" has been discussed several times in the DAC. At the 2003 and 2004 Senior Level Meetings, a suggestion was made to apply an interest rate

1 . Another category of loans of the development finance institutions is "blended loans" consisting of a concessional and non-concessional component. These have generally been accepted as concessional, because of the presence of a concessional component.

2 . http://www.oecd.org/dac/38429349.pdf, paragraph 37. In the Directives, ODA consists of flows "to countries and territories on the DAC List of ODA recipients and to multilateral development institutions" (paragraph 37) "by governments or the official sector of DAC countries" (paragraph 6).

3 . The grant element test is a mathematical calculation based on the terms of repayment of a loan. Members provide information on loan terms (grace period, maturity and interest) loan by loan in the Creditor Reporting System and the grant element is calculated as part of the data entry procedure. Loans for which the terms are not available cannot be included in ODA, since the grant element cannot be calculated.

cap of 75% of the relevant Differentiated Discount Rate, a reference rate used in concessionality calculations for tied aid and export credits. However, consensus was not reached on this. As interest rates rose towards 2005, the issue became less urgent, as the grant element test regained effectiveness as a concessionality test.

6. With the global financial crisis in 2008, interest rates fell sharply and have remained at historic lows ever since in several OECD countries. As in 2001-4 it has become easy to lend at or above long-term bond rates, while still meeting the 25% grant element test. For example, a 15-year loan with annual repayments and no grace period would meet the grant element test with an interest rate of 4.75%, whereas several G7 countries' 10-year bond rates are around 2%.

7. The development finance landscape is changing, and members are developing new financing instruments. At the same time, some members are finding it challenging to deliver on their commitments to increase ODA. Ways in which ODA could be increased without budgetary costs may therefore seem attractive.

Concessionality of EIB loans

8. Some European Investment Bank (EIB) loans benefit from a subsidy from the European Development Fund (EDF), and these loans have always been reported and accepted as concessional. However, with effect from 2009 reporting on 2008 flows, the EU started providing detailed information on the terms of EIB loans in the Creditor Reporting System and commenced reporting as concessional other loans that had not been subsidised. Once the Secretariat realised that these loans had been made from funds that the EIB had raised on capital markets and re-lent at harder terms, it advised that they should not be considered concessional in character. A lengthy correspondence ensued.[4]

9. In DAC statistics[5] the EIB is treated as a multilateral institution. In these cases the Secretariat assesses concessionality on the following basis:

> *"the grant element concept is not applied to the market-based lending operations of the multilateral development banks. Instead, these are classified as concessional if they include a subsidy ('soft window' operations) and non-concessional if they are unsubsidised ('hard window' operations)."* [6]

10. The Secretariat therefore asked the EU to specify which loans had been subsidised, so these could be included as concessional as was done up to 2008, with the remainder being reported as non-concessional. The EU declined to do this, since the requirement for a subsidy was not written in DAC Directives. Since the Secretariat was then unable to determine, according to its publically stated criteria, which EIB loans since 2008 were concessional and which were non-concessional, it has not shown these loans under either category since that year.

11. Inclusion of EIB loans without a subsidy as concessional would trigger the question of how to categorise the unsubsidised loans (hard window operations) by other multilateral financial institutions (MFIs). If the same treatment were applied to all institutions considered multilateral in DAC statistics then the bulk of these loans, which total on the order of USD 50 billion per year (gross disbursements), would henceforth need to be considered as concessional, a very substantial increase in

4. See DCD/DAC(2012)22 for part of this correspondence.

5. http://www.oecd.org/dac/38429349.pdf, page 56.

6. http://www.oecd.org/dac/dacglossaryofkeytermsandconcepts.htm#Grant_Element

overall aid volumes. But if the unsubsidised loans of these institutions continued to be treated as non-concessional, then treating EIB differently from other MFIs by applying a different definition of concessionality to its operations would introduce what some might consider a major inconsistency in the DAC statistics. A possible response to such criticism would be to underline the special character of the EIB compared to other institutions treated as multilateral in the DAC statistics.

Concessionality of loans by France and Germany

12. In recent years it has also become apparent that France and Germany have been lending at similar terms to the EIB, and the issue of the concessionality of these loans has been raised in Peer Reviews.[7]

13. The established practice of requiring a subsidy for loans to be reported as concessional is not as clear in the case of bilateral donors as it is for MFIs. However, DAC countries' reporting of loans as concessional is subject to two measures that do not apply to multilaterals:

i) The grant element test described above, which must be met by <u>each</u> loan.

ii) The DAC Recommendation on the Terms and Conditions of Aid[8] under which "Members should endeavour fully to maintain or achieve as soon as possible an <u>average</u> grant element in their ODA commitments of at least 86 per cent."

14. The first of these requirements, the grant element test, is as stated above, largely ineffective at present, since market interest rates in most currencies are well below the reference rate of 10% used in the grant element calculation. The second requirement is more constraining, especially if the loan share in a DAC country's ODA is high. For a loan share of 50%, reaching an average grant element in total ODA of 86% requires an average grant element in the loans of at least 72%. France failed to meet the 86% test in 2010.

15. Following emphasis by the DAC on securing equal treatment of all DAC members, the Secretariat asked both France and Germany late in 2012 to identify which loans included in their ODA reporting represented market-raised funds being on-lent at harder terms, i.e. without a subsidy. This information is still pending.

The magnitude of the problem

16. Ten DAC countries reported concessional loans for 2011. These amounted to USD 19.1 billion (commitments). The loan share of total DAC countries' ODA was 11 per cent, with five countries well above the average (Korea 55%, Portugal 46%, Japan 43%, France 27% and Germany 17%) and five others well below (Italy 3%; Australia, Belgium, Finland and Spain 1% or less).[9] Taking into account both the volume and the terms of repayment of the loans[10], further analysis is warranted for two countries while

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7 . The requirement for a loan to be concessional, in addition to meeting the grant element test was flagged in the 2010 review of Germany [DCD/DAC/AR(2010)2/01/PART1, paragraph 11], and in the mid-term review of France [Letter to DAC Delegates by DAC Chair Eckhard Deutscher, ED(2010)48, 18 October 2010].

8 . http://www.oecd.org/dac/aidstatistics/31426776.pdf

9 . Analysis on a gross disbursement basis produces similar results, with the exception for Korea. (The loan share in Korea's total ODA gross disbursements in 2011 was 33%.)

10 . See http://www.oecd.org/dac/aidstatistics/statisticsonresourceflowstodevelopingcountries.htm, tables 13 and 22.

current reporting from the other loan-providing countries does not suggest a major problem with concessionality. Only France and Germany extended loans with interest rates above 2% in 2011 (and Spain did so in 2010). Loans by the other countries with significant loan shares – Korea, Portugal and Japan – had lower interest rates, as well as generally longer grace periods and maturities.

17. Non-concessional loans (excluding export credits) reported by DAC countries amounted to USD 20 billion in 2011. About a half of this amount relates to Japan, one-quarter to Korea, with the remaining one-quarter coming from the United States (12%), Germany (7%) and France (6%). A quantitative definition of concessionality in character could have an impact on the categorisation of these loans, which should therefore be included in any further analyses on the subject. At the same time, introducing a practice where – in the absence of a commonly agreed definition – members are basically free to report loans as ODA as long as these meet the grant element criterion, could also be an incentive for other DAC members who have so far reported unsubsidised loans as non-concessional, to modify their reporting practices. This could lead to substantial adjustments in ODA volumes which would require explanation.

18. The MFIs' soft window gross disbursements amounted approximately to USD 19 billion in 2011 and their hard window operations to USD 41 billion. As regards the latter, the highest interest rate reported on an IBRD (i.e., non-concessional) loan was 2.8%.

19. Annex 1 shows the loans in 2010 and 2011 from the EU, France and Germany at interest rates higher than 75% of the DDR (a benchmark suggested by the former DAC Chair, see next section). All the interest rates on these loans exceed the maximum rate charged on an IBRD loan in 2011, i.e. 2.8%. Moreover, most of the recipient countries were ineligible for IDA loans in the years concerned, i.e. they could not have received any concessional World Bank financing.

20. What emerges from the above analysis is that:

- Development finance is changing, and members are developing new approaches to financing to meet the evolving needs of different groups of developing countries, while facing strong pressures on their domestic budgets.

- The political importance and the visibility of funds reported as ODA compared to other types of development finance, creates an incentive to include new financing approaches in ODA reporting.

- Three DAC members – EU, France and Germany – currently include in their ODA reporting substantial volumes of loans at considerably harder terms than IBRD loans that are classified as non-concessional (in some cases with interest rates more than 2% above those charged on IBRD loans). Moreover, these loans are mainly used in middle income countries to which World Bank extends loans only on non-concessional terms.

- Through this practice a major inconsistency has been introduced in DAC statistics, since loans at similar terms from multilaterals and bilaterals are treated differently.

Challenges of harmonising criteria for concessionality

21. Extensive discussion in the DAC since mid-2012 has failed to reach agreement on the definition of concessionality that should apply to EIB loans, or those by France and Germany.

22. There was, however, agreement at the High Level Meeting that ODA reporting should:

- withstand a critical assessment from the public;
- avoid creating major fluctuations in overall ODA levels;
- be generally consistent with the way concessionality is defined in multilateral development finance;
- maintain the definition of ODA, and only attempt to clarify the interpretation of loans that qualify as ODA; and
- prevent notions that ODA loan schemes follow a commercial logic: this includes the principle that financial reflows should be reinvested as development resources.

23. Moreover, members agreed to:

- transparency regarding the terms of individual loans;
- ensure equal treatment of all DAC members;
- establish, as soon as possible, and at the latest by 2015, a clear, quantitative definition of "concessional in character", in line with the prevailing market conditions; and
- recognise development loans extended at preferential rates – whether "concessional in character" under a future post-2015 definition or not – as making an important contribution to development.

24. The implementation of the HLM agreement poses several challenges, but considering the current Directives and reporting practices a key challenge is how to ensure equal treatment of all DAC members while maintaining the consistency of the DAC statistics between multilateral and bilateral assistance.

25. Accepting the position of the EU, France and Germany expressed at the HLM, and treating them equally by including all their unsubsidised market-based loans as concessional, would create a major inconsistency in the treatment of bilateral and multilateral development assistance.

26. A possible means of meeting both criteria would be to move to a quantitative definition of concessionality that would apply across both bilateral and multilateral flows. The Chair had proposed a benchmark of 75% of the relevant Differentiated Discount Rate.[11] This benchmark would have allowed the bulk of loans reported as concessional by France, Germany and the EIB in recent years to be counted, though others would have been disqualified. However, this suggestion did not secure a consensus at the HLM.

27. Pending a clear definition of 'concessional in character', the Secretariat seeks the Committee's guidance on how to deal with members' reporting.

Secretariat approach to concessionality pending DAC definition of "concessionality in character"

28. Unless the DAC directs otherwise, and pending any changes that might be agreed in directives or practices, the Secretariat's approach will be guided by the following principles:

- the need to focus attention on the important longer-term agenda of changes in development finance, and suitable concepts and measures for monitoring post-2015 development finance;

11. DAC/CHAIR(2012)5.

- the need to give more recognition and attention to the increasingly important non-ODA part of development finance;
- the need to maintain the credibility of the ODA concept in the period leading up to 2015;
- the need to ensure comparability of donor effort across the DAC membership;
- the HLM undertaking to ensure equal treatment among DAC members;
- the HLM agreement that ODA reporting should be generally consistent with the way concessionality is defined in multilateral development finance; and
- the need to ensure full transparency on terms and conditions of loans reported as ODA.

29. On this basis, the Secretariat intends to continue its advice to all DAC members that loans that represent market-raised funds should only be reported as concessional if they have an element of official sector subsidy. This is in accordance with the well-established practice of the MFIs and seems to be the only way of securing consistency in the DAC statistics. The Secretariat will therefore continue its inquiries with respect to loans by France and Germany and to advise those countries and any others concerned not to report as ODA loans made from funds raised on capital markets and re-lent at harder terms.

30. Should some members not provide the necessary information to distinguish between subsidised and unsubsidised loans, the following three options are available to be applied equally to all such members:

- include all the loans reported as ODA by these members, but with full transparency about the terms and conditions of the loans and with a note from the Secretariat informing that for some members the reported figures include loans that have interest rates which are above the prevailing market rates[12] for these members;
- exclude all loans from these members; or
- make an assessment of the individual loans and include only those which have interest rates below the prevailing market rate for these members.

12 . See DCD/DAC(2007)39/FINAL, paragraph 27.

ANNEX 1

Table 1. 2010

Loans reported as ODA/concessional by the EU(EIB), France and Germany
in 2010 with interest rates greater than 75% of the DDR

EU(EIB)

crsid	recipient	is the recipient IDA-eligible?[1]	USD million	maturity	interest	project title
2009310045	Montenegro	Not eligible	4.0	10.33	3.68	MONTENEGRO LOAN FOR SMES KOM BANK BUDVA

France

crsid	recipient	is the recipient IDA-eligible?[1]	USD million	maturity	interest	project title
2010122800	Colombia	Not eligible	104.8	19.42	5.13	APPUI A INVEST DS ENTITES TERRITORIALES
2009130300	Madagascar	Eligible	0.0	9.92	5.00	FINANCEMENT DU DEVEL. INSTITUTION MCF
2010102400	Mauritius	Not eligible	165.6	20.00	4.69	AIDE PRG ENVIRNT MAURICE ILE DURABLE
2010102900	Vietnam	Eligible	132.5	20.08	4.67	AMELIORA° EFFICACITE INVEST PUBLIC
2010106200	Morocco	Not eligible	317.9	13.92	4.58	SYST.MINERODUC POUR TRANSPORT PHOSPHATE
2010101000	Mexico	Not eligible	245.0	20.00	4.44	APPUI LUTTE CONTRE LE CHANGT CLIMATIQUE
2010124600	Mayotte	Not eligible	19.9	19.01	4.25	FINCT PARTIEL BUDGET INVEST 2010
2010103900	Mayotte	Not eligible	26.5	20.17	4.20	FIN.PARTIEL DU BUDGET D'INVESTIS.2009
2010111100	Indonesia	Not eligible	34.7	14.58	3.93	RENOVATION RESEAU ELECTRIQUE JAVA/BALI
2010106900	Indonesia	Not eligible	244.5	14.75	3.86	PRG DE LUTTE CONTRE LES CHGTS CLIMATIQUE

Germany

crsid	recipient	is the recipient IDA-eligible?[1]	USD million	maturity	interest	project title
2010001323	Albania	Not eligible	50.0	14.92	4.86	110-kV-Circuit Line South Albania
2010001329	Albania	Not eligible	55.6	14.92	4.81	400-kV-Transmissionline Tirana-Prishtina including high voltage equipment
2010001379	Tunisia	Not eligible	62.3	15.00	4.53	Réseau ferré de Tunis
2010001366	China	Not eligible	26.5	15.67	4.31	Shangqiu Normal University Project
2010001367	China	Not eligible	132.5	15.67	4.29	Financing of the construction of the Rail Transit Line Chongqing II
2010001360	Armenia	Blend country	26.5	10.17	4.10	Housing Finance III (IS) (Promotion of Mortgage Market)
2010001297	China	Not eligible	4.8	10.00	4.02	Municipal Sewerage Treatment Programme III

[1] For explanation of IDA-eligibility column see http://www.worldbank.org/ida/borrowing-countries.html.

Table 2. 2011

Loans reported as ODA/concessional by the EU(EIB), France and Germany in 2011 with interest rates greater than 75% of the DDR

EU(EIB)

crsid	recipient	is the recipient IDA-eligible?[1]	USD million	maturity	interest	project title
2010001284	Montenegro	**Not eligible**	2.8	11.75	4.04	MONTENEGRO LOAN FOR SMES INVESTBANKA C
2009310030	Serbia	**Not eligible**	34.1	21.01	4.02	EMS ELECTRICITY NETWORK UPGRADING
2009310058	Egypt	**Not eligible**	69.5	22.17	3.98	WIND FARM GULF OF EL ZAYT
2011001221	Jordan	**Not eligible**	112.6	12.58	3.85	JORDAN INDIA FERTILIZER
2011001220	Chile	**Not eligible**	76.9	9.08	3.72	LAJA HYDRO POWER PLANT PROJECT

France

crsid	recipient	is the recipient IDA-eligible?[1]	USD million	maturity	interest	project title
2011105100	Colombia	**Not eligible**	187.1	19.01	5.46	FINANCEMENT DU TRANSPORT URBAIN
2011128300	Madagascar	**Eligible**	1.6	9.01	5.00	PCF LIGNE DE CREDIT
2011110100	Mexico	**Not eligible**	417.1	15.92	4.53	FNCMT DE LA POLITIQ. CHANGEMENT CLIMAT
2011116500	Vietnam	**Blend country**	48.7	19.58	4.14	CONTRIBU° PRG RéFORME INVEST PUBLIC VN
2011104400	Togo	**Eligible**	0.0	7.92	4.00	REFINCT PORTEFEUILLE CREDIT WAGES
2011105500	China	**Not eligible**	55.6	17.00	3.83	PRG INSTALLA° RESEAUX CHALEUR TAIYUAN
2011112000	Tunisia	**Not eligible**	20.9	19.42	3.81	CONSTRUCTION éCOLE NATIONALE D'INGéNIEUR
2011110800	Cote d'Ivoire	**Eligible**	486.7	9.00	3.78	REDRESST FINANCES PIBLIQUES RELANCE éCO
2011109800	Tunisia	**Not eligible**	257.2	17.00	3.75	SOUTIEN PLAN APPUI RELANCE GVT TUNISIEN
2011110700	Brazil	**Not eligible**	50.3	20.25	3.50	PROG.MUNICIPAL CURITIBA ENVIRT URB & TRA
2011103500	Mali	**Eligible**	0.4	7.67	3.39	CONTRIBUTION FINANCEMENT ESE JMI AGRO
2011119500	Turkey	**Not eligible**	208.6	14.92	3.32	LUTTE CONTRE LE CHGT CLIMATIQUE
2011122100	(Regional organisation)	**Not applicable**	5.6	14.92	3.31	FINANCEMENT D'UNIVERSITéS
2011120100	(Regional organisation)	**Not applicable**	193.8	12.00	3.30	REFINCT CREDIT CROISSANCE VERTE

Germany

crsid	recipient	is the recipient IDA-eligible?[1]	USD million	maturity	interest	project title
2011001228	Tunisia	**Not eligible**	14.0	12.00	4.64	Waste Deposits such as construction of purification plants
2011001227	Tunisia	**Not eligible**	7.8	40.00	4.64	Waste Deposits such as construction of purification plants
2011001434	China	**Not eligible**	48.7	15.33	4.54	Bayannaoer Waste Water Treatment and Reclamation Plant
2011001429	China	**Not eligible**	27.8	15.00	4.52	Suining Municipal Infrastructure
2011001364	Georgia	**Blend country**	27.8	15.33	4.20	Municipal Infrastructure Batumi III
2011001425	China	**Not eligible**	20.9	15.17	4.16	Dongfang Hospital Luoyang
2011001427	China	**Not eligible**	20.9	13.67	4.05	Improvement of Vocational Education in Mudanjiang University
2011001426	China	**Not eligible**	25.0	15.17	3.93	Health Programme Hunan - expansion of hospitals
2011001356	China	**Not eligible**	80.6	15.25	3.86	Luan Sewage Treatment - Construction of a purification plant
2011001368	Serbia	**Not eligible**	24.3	15.25	3.49	Water Supply and Sewage Disposal
2011001349	Serbia	**Not eligible**	29.2	8.00	3.43	Energy Efficiency and Renewable Energy Programme
2011001381	Costa Rica	**Not eligible**	27.1	12.00	3.32	Credit Line for Small to Medium Sized Enterprises
2011001382	Costa Rica	**Not eligible**	14.5	12.00	3.32	Credit Line for Small to Medium Sized Enterprises

[1] For explanation of IDA-eligibility column see http://www.worldbank.org/ida/borrowing-countries.html.