Expert Reference Group Meeting – 26-27 June 2014

Session 3

Better representing the donor effort in non-grant instruments – principles and methods

Background

Non-traditional instruments in development finance, such as equity and mezzanine investments or guarantees, are generally acknowledged as an important complement to grants and loans to directly support private sector development. They also have the potential to crowd in additional public and private resources required to support the full scope of the post-2015 sustainable development goals. However, the current DAC statistical system and the reporting based on net disbursements disincentivise their use. Mezzanine finance or equity investments are either non ODA-eligible or result in negative net ODA because of higher returns or positive sales proceeds arising from the additional risk inherent in these instruments. Guarantees are not captured in ODA either, as the current statistical system is cash-based and guarantees do not generate a flow from the official sector until their activation. This implies that the reporting system gives more credit to interventions that fail rather than succeed (e.g. guarantees that are being called upon, equity investments that are impaired).

The DAC is exploring how these instruments could be better valorised within ODA and/or the proposed new measure of Total Official Support for Development (TOSD). For example, consistent with the debate on modernising the measurement of loans, ODA could include the concessional component (grant equivalent) of such instruments while the face value (gross disbursements) could be included in a measure of TOSD. The leveraging effect of these instruments could be valorised by separately tracking and recording the additional amounts mobilised.[1]

With regards to ODA, the overarching challenge is how to decide whether guarantees, mezzanine finance and equity can be concessional, and if yes, how to measure their concessionality.

Questions:

- ODA is a measure of development finance that is considered to be concessional in character. There is, however, no commonly accepted (quantitative) definition of what this means for non-traditional instruments. How could concessionality be defined in the contexts of guarantees, mezzanine finance and equity?
- Can the grant equivalent approach, in analogy to the considerations for modernising the ODA reporting on loans, be applied to other non-grant financial instruments?

[1] To the extent data allow.

- If not or not for all instruments, how can the donor effort in guarantees, mezzanine finance or equity, if any, be captured?

Annex / Links:

- Annex 1 - Possible options for measuring equity in ODA
- For more information on guarantees for development, please refer to http://www.oecd.org/dac/stats/guaranteesfordevelopment.htm

ANNEX 1 - POSSIBLE OPTIONS FOR MEASURING EQUITY IN ODA

1) **Measurement of net cash flows**, i.e. disbursement from initial investments are reported as positive entry in ODA and amounts received from divestments are reported as negative entry in ODA (no consideration of dividends).[2] Thus, successful investments - i.e. investments that have supported a sustainable and profitable business - generate negative ODA over time because the amounts flowing back are higher than the amount initially invested. On the other hand, investments in unsustainable or even failed businesses are generating positive ODA as the repayment amounts fall short of the initial investment.

→ Maximum ODA: initial investment value
→ Minimum ODA: negative
➔ Incentive implications: Measurement gives highest recognition to failed projects. The better investee businesses perform (substantiated by a higher investment returns), the lower the ODA contribution (negative).

This is the current method of reporting on equity in ODA. (However, not all DAC members' DFIs are reporting on equity in DAC statistics. Consequently, DFI operations are currently not accurately recorded.)

2) **Measurement of net cash flows limited to initial investment value**, i.e. amounts of the initial investment are reported as positive entry in ODA and amounts received from divestments are still reported as negative entry in ODA but limited to a maximum of the initial investment value. This means that the repatriation of capital would still be accounted for as a negative flow but not any dividends and sales gains. This would mirror the current treatment of ODA-eligible loans for which only principal but no interest repayment is accounted for in the net measure. Thus, successful investments are eventually counted as zero in ODA statistics (same as loans in the current system) whereas unsuccessful investments produce positive ODA.

→ Maximum ODA: initial investment value
→ Minimum ODA: zero
➔ Incentive implications: Measurement still gives highest recognition to failed projects but limits the negative impact of successful projects.

This adaption of 1) would align the reporting of market-based instruments to the current reporting practise on loans and thereby potentially reduces the disincentives to report on the former. However, it still comprises the same shortcomings for essentially the same reasons as 1).

[2] For details see para 16, 82, 100 and 183 in the OECD DAC Converged Statistical Reporting Directives for the Credit Reporting System (CRS)

3) **Measurement of grant equivalents**, i.e. difference between face value and net present value calculated with an appropriate (expected) risk-adjusted rate of return. Theoretically desirable but practically challenging for different reasons; the major one being that future proceeds are uncertain and the risk assessment is highly subjective. While investment decisions by any financial institution (FI) are based on an expected rate of return, the calculation of which is based on a wide set of estimates, the actual results can and do differ considerably. This means that an anticipated grant equivalent for any given equity investment is very unlikely to capture the true effort of the donor in providing the investment. The effect is limited in FIs by taking a portfolio view in which the outliers are netting themselves off, resulting in the actual portfolio return getting closer to the anticipated one. However, the results will still differ widely amongst institutions, portfolios as well as inter-temporally.

→ Maximum = Minimum ODA: grant equivalent

➔ Incentive scheme: Neutral when compared to other types of loan and equity investment as long as a risk-adjusted discount rate is used. However, neither the appropriate discount rate nor future cash flows are known upfront, i.e. parameters for the calculation are not available.

This method would fit in best with the currently discussed shift of the ODA accounting of loans from net flows to grant equivalents. There are, however, technical issues of how to calculate this.

Is there a way to calculate or approximate a grant equivalent for equity? Could ODA be based on the provisions made by the investing financial institution? What assumption would need to be made?

4) **Measurement of gross cash flows**, i.e. equity is accounted for on a gross cash basis (face value), no deduction of capital repatriation, dividends and sales proceeds. This would mean that equity is treated the same way as grants whereas the recovery of the initial investment value as well as value gains are generally expected on an aggregated average level. While it is a technically feasible measure to recognise and not "punish" successful equity investments, it is likely to result in an overestimation of the donor effort.

→ Maximum = Minimum ODA = face value

➔ Incentive scheme: Incentives biased in favour of equity investments.

Politically not feasible since most DAC members would object this option for lack of fairness and credibility.

5) **Differentiating between different classes of equity and accounting for some in ODA and others in TOSD**, i.e. instead of trying to calculate the provider effort by trying to measure and account for concessions, if any, embedded in these instruments, define criteria that draw a line between investments considered as concessional in character and investments that are not considered concessional in character. The former would be accounted for in ODA on a gross cash basis. The latter would be accounted for in TOSD on a gross cash basis. Options for distinguishing may include but are not limited to country risk (e.g. investments in the riskiest countries as classified by the OECD

country risk classification may be considered concessional by definition), structured risk (e.g. first-loss shares that provide a risk protection to superior equity investors, noteholders and other creditors may be considered concessional by definition), investment horizon (e.g. investments with a holding period above a certain threshold may be considered concessional by definition), additionality (e.g. primary issues are considered more developmental and riskier and more concessional than secondary trades). Another obvious criterion is the expected risk-return profile that could be benchmarked against the market to draw the line between concessional and non-concessional investments. However, defining the market would be challenging.

→ Maximum = Minimum ODA = face value
➔ Incentive scheme: Does incentivise equity investments in high-risk environments and/or enterprises with a lower than commercially expected (or hardly any) return in principle. Depends on how the line is drawn in reality.

May be a technically and politically feasible compromise.

What should be the principles in defining the ODA boundary? Which criteria (or combination of criteria) for differentiating between concessional and non-concessional equity may be considered practically feasible and politically credible?

6) **Other options?**