Expert Reference Group Meeting – 23-24 January 2014

Session 3 – From a Political to a Market Perspective on Concessionality?

Discussion Paper[1]

Background

The definition of concessionality is a key factor in the measurement of development finance. In DAC statistics, concessionality determines the eligibility of a transaction to be reported as ODA. At present, transactions that convey a grant element of at least 25 per cent, calculated with a discount rate of 10 per cent, and that are "concessional in character", qualify as ODA.

As development finance has evolved over time, variability in donor interpretations regarding the meaning of "concessional in character" has led to the reported figures not being endorsed by all the members, with regards to loans extended from funds raised on capital markets without any official public sector direct subsidy. The DAC is committed to updating and refining its statistical reporting directives by 2015 to ensure consistency in the application of "concessional in character" in the reporting of ODA.

In this context, and to address the DAC High Level Meeting principles and decisions (see Box), options for revising the assessment of concessionality and the reporting on loans in DAC statistics are being explored. Concrete proposals will be elaborated over the next few months, also taking into consideration the emerging new measure of total official support for development, new approaches to measurement of donor effort and possible modernisation of ODA, equally mandated by the HLM.

Box. DAC High Level Meeting principles and decisions regarding concessionality in character

At the 2012 HLM, the DAC agreed on several principles regarding concessionality in character. These are that ODA reporting should: i) withstand a critical assessment from the public; ii) avoid creating major fluctuations in overall ODA levels; iii) be generally consistent with the way concessionality is defined in multilateral development finance; iv) maintain the definition of ODA, and only attempt to clarify the interpretation of loans that qualify as ODA; and v) prevent notions that ODA loan schemes follow a commercial logic: this includes the principle that financial reflows should be reinvested as development resources.

The HLM also decided: i) on transparency regarding the terms of individual ODA loans; ii) to ensure equal treatment of all DAC members; iii) to establish, as soon as possible, and at the latest by 2015, a clear, quantitative definition of "concessional in character", in line with prevailing financial market conditions; and iv) to 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.

[1] The ideas expressed in this working paper do not necessarily represent views of the OECD, the OECD's Development Assistance Committee (DAC), or their member countries, or the endorsement of any approach described therein.

Issues

The matrix below presents in a succinct manner the options discussed so far with regard to: a) the choice of discount rate; b) measuring loans on the basis of cash flows or their grant equivalents; and c) accounting for risk-taking. There is an emerging understanding that:

- **the option to be developed with priority could be:**
  - measuring ODA provided in the form of loans on the basis of their grant equivalents, calculated using a currency and risk differentiated discount rate, and
  - capturing actual cash flows (including interest) in the data on "developing countries' resource receipts".
- **another option to explore further could be:**
  - as above, but harmonising the discount rate with that applied by IMF/WB, determining however a methodology for regularly evaluating and adapting this fixed rate.
- **maintaining the existing discount rate and reporting on cash basis is not an option**; and
- **reporting on debt relief would need to be revised if the risk of default were built in the assessment of loan concessionality.**

Questions for discussion

Building on issues highlighted in the matrix, participants are invited to discuss the pros and cons of moving to a measurement system based on:

- risk-adjusted discount rates, in comparison with the DDR or a regularly updated fixed rate; and
- grant equivalents (on a commitment basis or year-by-year), in comparison with government subsidies softening the terms proposed by loan-extending institutions.

Moreover, considering concessionality of development finance from the perspectives of development finance providers and recipients, participants are invited to discuss the following:

- what is the right benchmark to measure concessionality?
- what incentives are required for an efficient and effective use of funds?
- how to avoid perverse incentives?
- How should debt forgiveness be accounted for if risk is measured upfront?

Matrix of options for revising the assessment of concessionality and the reporting on loans in DAC statistics

A. Which discount rate?

Options	**Advantages**	**Disadvantages**
A1: 10%	Maintains continuity with current DAC statistics.	No longer reflects "prevailing financial market conditions" (HLM decision iii). Higher than rates of return now required for public investments in member countries (no longer reflects the "opportunity cost" of making funds available for aid). Has been subject to widespread public criticism as providing too lax a test (HLM principle i). May not prevent notions that ODA loan schemes follow a commercial logic, since commercially viable lending can be extended at rates well below 10% (HLM principle v).
A2: 5%	Credible as a proxy for providers' current funding costs. Identical to the interim solution adopted by IMF/WB for use in Debt Sustainability Framework for Low Income Countries. More comparable with rates of return required for public investments in member countries.	Does not take into account the fact that providers' funding costs differ depending on the country and currency (despite some convergence in recent years). Does not reflect default risk (though this may not matter if actual default gives rise to ODA through reporting of debt relief, see Section C).
A3: DDR (Differentiated discount rate used by the OECD Export Credit Group to assess concessionality of tied aid)	Differentiated for donors. Retains a permanent link to prevailing market conditions.	Does not reflect default risk.

A4: Currency <u>and</u> risk-differentiated discount rates	Represents complete *ex-ante* assessment of concessionality, taking account of both cost of borrowing and risk of default. Differentiated for both donors and recipients. Can be seen as offering fair basis for burden-sharing comparisons among loan extending donors.	Loans with the same terms would be assessed differently in different years, from different donors, and to different recipients. Would require revising reporting on debt relief, since default risk accounted for up-front, see Section C.

B. Cash flows or grant equivalents?

Options	**Advantages**	**Disadvantages**
B1: Flows of capital (disbursements positive, repayments of loan principal negative)	Maintains continuity with existing system. Represents actual flows, so is more recognisable to recipients and commensurable with data on other items in the balance of payments.	Does not reflect provider effort (e.g. a loan with 0% interest counts the same in net ODA as a loan with 5% interest). Creates disincentive to offer loans due to zero ODA in the long run. Does not allow accurate comparisons of burden sharing between donors that offer grants only and those that offer both grants and loans. Provides an unrealistically sharp dividing line between loans that just qualify as ODA (counted in full) and those that just fail to qualify (not counted in ODA at all).
B2. Transfers (disbursements positive, repayments of loan principal <u>and</u> <u>interest</u> negative)	Fair measurement of flows from a recipient perspective. Responds to critique from NGO/research community.	Creates strong disincentive to offer loans due to negative ODA in the long run.

B3. Grant equivalent (i.e. loan amount multiplied by its grant element) *For details on possible implications, see* http://dx.doi.org/10.1787/5k3v1dv3f024-en	Donor effort varies with degree of concessionality and allows recognising the effort in extending less concessional loans Provides basis for assessing burden sharing between all-grant and grant-and-loan donors. Can capture small elements of concessionality incorporated in projects.	Breaks continuity with earlier figures, although historical data series could be re-calculated. Assesses effort but is a notional quantity: the grant equivalent is calculated on a commitment basis, and would be difficult to describe as a disbursement. Not necessarily an intuitive measurement, due to complex mathematical assessment of the present value. Impact on figures depends heavily on the choice of discount rate.
B4. Year-by-year assessment of the grant equivalent (calculated as the difference between what the payment would have been on market terms and actual payment)	As for B3, but smoothes out reporting of concessionality in line with actual yearly transactions.	As for B3, but could be more difficult to implement in practice.
B5. Government subsidy to soften the terms proposed by loan-extending institutions	Consistent with the treatment of associated financing in current statistics.	Not all concessional loans involve an explicit government subsidy. May have to be applied at the level of institutions rather than individual loans. Could not apply where budgetary funds (general government revenue) is used to finance lending.

C. Accounting for risk-taking

Options	Advantages	Disadvantages
C.1 Upfront, using a risk-adjusted discount rate	Would simplify reporting as debt relief (i.e. realised risks) may no longer have to be reported.	Depending on discount rate chosen, might be considered as overestimating donor effort.

C.2 Debt forgiveness	Maintains continuity with existing system. May be more consistent with Paris Club and Balance of Payments reporting conventions.	Valorises failures (ODA credit given for cancelling non-performing debt). Current method overestimates costs to the donor (by counting amounts cancelled rather than costs to governments of purchasing debt or indemnifying debtors, and neglecting to count premia paid to purchase insurance against defaults). Results in large fluctuations in ODA levels when debt restructured in Paris Club or otherwise.