

# HOW TO ACCOUNT FOR CONCESSIONAL LOANS IN AID STATISTICS?

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Since 1972, the donors of the Development Assistance Committee (DAC) of the OECD measure Official Development Assistance (ODA) to determine which expenditures are sufficiently development related to be considered as aid. While the definition has in the intervening decades come under close scrutiny and repeated criticism, it has only been marginally adapted. Recently however, the controversy about the ODA definition has heated up. The fact for instance that some donors have been able to include, as ODA, loans to developing countries raised through the financial market without any explicit subsidy being added, has more than raised eyebrows. How can such transactions qualify as ODA, a concept commonly understood as requiring both development intention and (budgetary) effort on the part of the donor (Hynes and Scott, 2013).

At their December 2012 High Level Meeting, the DAC acknowledged the need to modernize its development finance framework. A temporary solution was put into effect in 2013-2014, with the intention to agree on “a clear, quantitative definition of ‘concessional in character’, in line with prevailing financial market conditions” by 2015. Following two years of discussions, proposals and most recently of a High Level Working Group, all this work should culminate in a new way of accounting loans in ODA statistics at the December 2014 DAC High Level Meeting in Paris.

In this policy brief, we start by clarifying the current ODA accounting rules for loans used by the DAC. In the subsequent sections we will discuss some desirable features of a potential new accounting rule.

## Current DAC accounting rules

In order to aggregate grants and loans in a common aid metric, one needs to deal with the element of inter-temporality: in addition to the initial loan disbursed in the given year, the future reflows of capital and interest payments must be taken into consideration. An elegant way to collapse future and present flows in a single number is to calculate the Net Present Value (NPV) of the loan. Selecting an appropriate discount rate reflecting the opportunity cost to the donor (at least if the intention is to measure the contributions of DAC donors to a global public good), all future debt service payments are expressed in equivalent flows in the year the loan is provided, to obtain the Present Value (PV) of reflows to the donor. By subtracting this PV from the nominal loan (L), one arrives at the so-called Net Present Value (NPV). This NPV can also be called the ‘Grant Equivalent of the loan’ (GE); essentially, it provides a measure of the degree of ‘equivalence’ of the loan to a grant provided in the base year. When dividing GE by the amount of the loan, one obtains the so-called grant element of the loan.

$$\text{Grant element} = \frac{L - PV}{L} = \frac{NPV}{L} = \frac{\text{Grant Equivalent (GE)}}{L}$$

For a grant, the GE equals L (as PV = 0, there are no reflows), so the grant element is 100%. For a commercial loan, it will be zero (if we assume that the opportunity cost discount rate is given by prevailing market rates) as the present value of reflows (PV) exactly matches the amount of the loan L, so GE is equal to zero. Such a method not only allows to add grants and loans for a given donor in a meaningful

way, it also allows to compare the concessionality of loans across different donors, taking into account differences in interest rates, tenor, grace period and principal repayment schedules. This method also allows to compare the efforts of donors providing mainly grants to those with a more diversified portfolio of grants and loans. It is on this last point that the current DAC accounting rules fail.

The current rules calculate the GE and grant element using a fixed 10% discount rate, to determine whether a loan has a grant element of at least 25% and is thus sufficiently concessional to qualify as ODA. Loans that satisfy this threshold are accounted for using a cash flow (CF) approach: the full nominal value of the loan is added as ODA in the year it is provided, while principal repayments enter as negative entries in the years they occur; interest payments enter only as a memo item. Loans below the threshold are not accounted for at all in ODA. One consequence of this approach is that, over time, the net ODA of a fully-repaid loan is equal to zero.

### **Grant Equivalent (GE) versus Cash Flow (CF)-based approaches**

The current ODA accounting system based on a cash flow (CF) methodology is a very imperfect method to measure donor effort. By accounting for donor nominal cash outflows and (principal only) reflows in the year they occur, the cash flow method overestimates the concessional nature of the transaction, as it ignores the interest payment reflows, so differences in loan interest rates do not appear in the ODA metric; by the same token, differences in timing of reflows are not adequately taken into account.

If ODA is meant to correctly measure donor effort involved in ODA provision, an NPV-based method, such as the Grant Equivalent (GE) is a much more consistent measure of donor effort. This measure includes as ODA the GE of the loan at the moment when it is provided, without any future (negative) entries. As such it provides a nuanced and consistent measure of donor effort, taking into account differences in interest rates, tenor, grace period and principal repayment schedules. Furthermore, a Grant Equivalent (GE) principle also provides a good basis to account for other donor interventions, such as donor guarantees, that may include a genuine donor effort, but are difficult to account for in CF terms.

Note also that, compared to the current approach where, summed over time, the net ODA of a loan is always zero, a GE calculation generates a positive ODA result for any loan that is provided on softer than market conditions. Thus the use of loans is favoured more than is currently the case, and for sound reasons, at least from the perspective of donor effort.

### **The choice of discount rate**

As ODA aspires to measure donor effort, the discount rate used in these NPV and GE calculations should reflect the donor's (public sector) opportunity cost. The interest rate on long term government securities can serve as a readily available proxy. It expresses the interest rate the donor public sector has to pay to raise resources in the capital market. Of course, this is strictly speaking only correct if donors fund aid by borrowing on the capital market, rather than by raising taxes or by reducing spending elsewhere in the public sector. And while some donors indeed rely to some extent on borrowing, that certainly does not account for most ODA loans. However, the use of market interest rates has wider applicability if financial markets are performing reasonably well and governments make efforts to optimise their investment and consumption spending. In such a scenario the opportunity cost of public investments, the opportunity cost of public consumption spending and the cost of borrowing will all converge.

As mentioned, the DAC has until now stuck to a fixed 10% discount rate. While this rate may have been an acceptable reflection of the public sector opportunity cost in DAC countries in the 1970s, it is much less the case today when some donors can borrow at less than 1 percent. Given this large gap between current donor interest rates and the 10%-discount rate, some donors can opt to borrow at market rates, add a commission, relend to a developing country without any budgetary effort on their part, and still count it as ODA under the current rules. Surely such practices threaten to undermine ODA credibility. What better approaches have been suggested?

A first proposal is to align with the basic discount rate applied by the IMF, which currently stands at 5%. This rate is constructed as the 10-year average US dollar 'Commercial Interest Reference Rate' (CIRR), an OECD-determined reference rate for private market borrowing, plus a margin of 1.15%, rounded to the closest digit. It is currently being

used by the IMF, for example in judging a country's long-term debt sustainability (IMF, 2013). Compared to the time-fixed DAC discount rate, the rate has the advantage of being based on more recent market circumstances, and it is equally easy to apply. However, a rate that is uniform across donors does not take into account the differences in opportunity cost between donor countries (say Japan versus Greece). Another disadvantage is the fact that it is a 10-year average, making it rather slow in responding to changing market circumstances and not a great proxy for the current opportunity costs of donors.

A second proposal is to use the Differentiated Discount Rate (DDR). This rate is also based on the CIRR and is already used by the DAC donors (except Iceland) within the OECD Export Credit Group for loans tied to donor's exports. As the rate is currency-specific, it better differentiates between donors, but fails to differentiate between the very different cost of public borrowing among Euro countries. The DDR also uses a 6 month window, which makes it more relevant for measuring donor borrowing costs today but may be too unstable for the purpose of the DAC. Furthermore it varies according to the maturity of the loan (for details in comparing the IMF and DDR approach, see e.g. Roodman, 2014).

In conclusion, both proposals on the table have been developed for other purposes and do not directly address the needs of DAC ODA accounting. If the choice is between the two discount rates on the table, the DDR most closely matches the logic of a differentiated donor borrowing cost measure. Instead of annually updating it, the DAC could decide to update more infrequently, say when the rate changes by at least one percentage point. But nothing should prevent the DAC from coming up with its own discount rate, more suited to its needs, possibly again based on the CIRR (as the two previous proxies), or based on observed public sector borrowing costs, especially if the ambition is to select donor-specific rates instead of currency-specific rates.

### **Adding a risk premium?**

An appropriate measure of donor effort should also allow for the probability that some or all of the reflows will not occur, i.e. the risk of non-repayment by the debtor, which confronts the donor with lost foreign exchange earnings and increases his cost of providing aid. In principle, there are two basic ways to incorporate this risk into the PV and GE measures, one ex ante (when calculating the GE of

the loan), and one ex post (i.e. if and when the non-repayment occurs). The ex-ante measure calculates the PV and GE of the loan incorporating an explicit assumption of the likelihood that some of the debt service payments will not or not fully take place. In the proposals, this has been translated by adding a risk-premium to the discount rate, which increases GE and the grant element. On the other hand, ex-post treatment would account for non-payment if, when, and at the rate it occurs, by increasing ODA with the additional donor cost of the forced or voluntary debt relief, in the year(s) it takes place, again appropriately measured (in GE terms).

The latter concept is more precise and thus in theory preferable. The first is necessarily a very imperfect ex-ante proxy of realized, ex-post risk. Limited data availability also makes it difficult to calculate a risk premium, as it ideally should be debtor-country specific. A recent French proposal suggests to estimate the risk premium using implied default rates based on information of rates at which these countries can borrow in private capital markets; it can be argued that these rates are not necessarily a good proxy of ex-post realised default by those debtors on their official bilateral loans; furthermore, for most low-income countries, the market does not provide such a risk premium so additional assumptions need to be made in order to come up with such a proxy. Note that in setting interest rates for multilateral lending to those countries ex-ante risk premiums are not used.

Higher upfront discount rates, incorporating a risk premium, would reward extending loans to high(er)-risk countries, as their GE would become larger. Advocates of the use of this ex-ante risk premium point out that this would favour lending to low income and least developed countries (LICs/LDCs), rather than to less-risky (upper) middle-income countries ((U)MICs). As such, it is suggested to attach fixed average risk premiums to different beneficiary country groups based on income level, with a low risk premium for UMICs and higher ones for LICs/LDCs. Such a grouping would be easier to implement, but might lead to considerable discrepancies between this average rate and the actual default risk of a particular debtor country. Moreover, while there is certainly a case to be made for additional financing to LICs/LDCs – additional in the sense that it would come on top of existing grant allocations, not at the expense of them- it is debatable whether providing more loans is desirable in countries with low (and unpredictable)

debt sustainability thresholds, and whether it constitutes the most adequate instrument for additional finance.

In addition, in case these high, market-based risk premiums are applied, it would (again) introduce a considerable ex ante wedge between the rates at which donors are able to borrow, and the (higher) risk-adjusted discount rate, and could end up in discount rates close to or even higher than the current (problematic) 10%, which would be hard to explain to the public; at least the impression would be created that things remain the same. In any case, using these high ex-ante risk premiums would grossly overestimate the amount of real ODA (donor effort) in case there would be only a small de facto realized degree of non-repayment; as the current proposals do not include a correction ex-post for this discrepancy, this may pose a fundamental credibility problem.

Taking risk into account ex ante, by adjusting the discount rate, would of course have the advantage to diminish the need for accounting rules to deal with non-repayment or debt relief later. But this has the disadvantage that in the case of defaulting, debt rescheduling or debt relief no longer counts as extra ODA, and as consequence donors might be much less inclined to offer debt rescheduling or debt relief to debtor countries when they are no longer 'compensated' for their generosity.

### **Using grant element thresholds?**

Under current rules, loans are only included as ODA when their grant element is at least 25%. Under the CF-methodology currently used, such a threshold however works as a filter, creating errors in two different ways. For loans that match the threshold, no distinction is made between more or less concessional loans; and loans that do not match the threshold do not enter ODA at all, although they may constitute a genuine cost to the donor. Applying the GE methodology basically solves this problem: even a small grant element leads to an equivalent small

amount of ODA.

Even so, one could argue in favour of using minimal grant element thresholds. Is it really valid that all loans with limited grant elements would be included in ODA? At huge volumes, they could still add up to considerable ODA; hence, minimal thresholds could remain important if the ambition is to dissuade donors to use of loans with marginal grant elements. In the end, setting a minimum grant element threshold is mainly a political decision. During the discussions decades ago, proposals ranged between 20% to 60% (Hynes and Scott, 2013). Although, today, alignment with already existing other practices would suggest a 35% grant element (IMF and the OECD Export Credit Arrangement practice), a combined use of the GE approach and such a high grant element threshold across the board would not be preferable. More useful, and similar to an argument raised in the discussion on the ex-ante risk premium, a differentiated use of thresholds could help in steering the use of loans for particular target groups. More particularly, a high threshold (some advocate for 50% as in the OECD Export Credit Arrangement) for LICs/LDCs would assure that loans towards those countries would remain sufficiently concessional.

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### **A NOTE ON ACROPOLIS**

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