**Draft Chair's Summary of Expert Workshop on Concessionality**

organised by the DAC Working Party on Development Finance Statistics (WP-STAT)

in Paris on 19 November 2013

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1. In her opening remarks, the Chair explained the background of the ongoing concessionality debate and recalled the agreements (at HLM[1], DAC and WP-STAT levels) that guide the work on elaborating a quantitative definition of concessional in character by 2015. She further informed participants of the broader discussions on measurement and monitoring external development finance post 2015, and stressed that proposals on concessionality needed to also take 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. The objective of the workshop was not to draft a quantitative definition of concessional in character, but to explore the landscape of different contexts, meanings and impact (on recipients) of concessionality in lending.[2]

2. Overall, the broadening of the discussion[3] brought in new perspectives and insights that will be useful in (re-)defining concessionality in line with the HLM decisions.

3. The meeting first looked at **the concept and the different contexts and meanings of concessionality from the perspective of providers**: the first session consisted of the IMF presenting the perspective of *multilateral lending and debt sustainability framework (DSF) for low-income countries* and France (Agence française de développement, AFD) the *bilateral development banks'* perspective, with Development Initiatives adding the views of *CSOs/research institutes from a critical external data use and analysis perspective*. The second session focused on *reporting rules and calculation methodologies* with presentations from the IMF (including an explanation of the October 2013 IMF/WB reform of discount rates), the Export Credit Division of the OECD Trade and Agriculture Directorate and the DAC Secretariat.

4. The **"recipient benefit" perspective** was discussed in the third session, with representatives from three partner countries (Malawi, Mozambique and Uganda). The Chair clarified that representatives from other regions (Asia, Latin America) and middle-income countries had been invited, but due to time and organisational constraints, they could not participate this time. Their perspectives should be fed into future discussions as concessionality in lending had a different impact for countries with different income status.

5. Summaries of main points in the discussions on provider and recipient benefit perspectives are given in the Annex. The **conclusions in short** were:

- **The current problems in the measurement of provider effort in the context of ODA reporting cannot be overcome by merely adjusting the fixed discount rate of 10%.** Structural problems in ODA reporting need to be addressed as well. A key structural issue is the recording of loans at full face value, with principal repayments later being

1 http://www.oecd.org/dac/HLM%20Communique%202012%20final%20ENGLISH.pdf

2 See opening presentation by the Chair for more details.

3 Over 130 participants attended the workshop, representing both DAC and non-DAC provider countries, seven international financial institutions, three research NGOs and three low-income countries. Staff from other OECD Directorates also attended.

deducted. This leads to all loans eventually summing to a flow of zero, regardless of their level of concessionality.

- The recent IMF/WB decision to adopt a unified 5% discount rate under DSF and debt limits policies up until 2015 was intended to address the operational problems experienced with the traditional currency-specific, CIRR-derived, maturity-based discount rates. There was little scope for OECD Export Credit Group to change its practices, so **complete harmonisation of methodologies to assess concessionality at the international level may not be possible at this stage**.
- There was no "perfect discount rate", so the rate chosen should not be applied in such a way as to rule in or out of ODA the entire face value of a loan.
- **At the IMF, concessionality is defined as lender's effort which is best measured by funding costs; the concept is thus useful to compare donor efforts and assess burden sharing. The 5% discount rate was a proxy for funding costs.** If only donors' costs but not their default risks were reflected in the discount rate, then actual default implied a fresh donor effort which would need to be measured.
- **Another alternative was to adopt a "risk-adjusted" discount rate which would add to the funding cost a variable premium to cover default risk.** The pros and cons of the alternatives need to be carefully examined.
- The HLM mandate to (re)define concessional in character by 2015 called for the DAC definition to "*be generally consistent with the way concessionality is defined in multilateral development finance*". When considering this criterion, it was necessary to bear in mind the different timelines of the IMF/WB (revision in 2015) and DAC (finalisation by 2015) processes.
- There was an emerging understanding that one option to overcome the structural problems related to the treatment of lending operations in current ODA statistics could be to **i) measure "provider effort" by the grant components of loans (either the "grant equivalent" of loans or the actual subsidies injected in the loans), and ii) capture the actual cash flows in the data on "recipient receipts"**.
- The above approach would imply a more pronounced distinction between the two points of measurement of the statistical system. The second measure would be close to "recipient receipts" but **"recipient benefit"** was a different notion. Based on partner country representatives' views on what constituted a "benefit" for them, this would need to be a **qualitative indicator**. (Most of the aspects they mentioned could not be captured in quantitative terms.) Devotion, i.e. what project/undertaking the financing is used for, and quality aspects needed to be factored in.
- The meeting also noted that although levels of concessionality did matter to developing countries, **concessionality was to be considered as a continuum rather than a binary variable** ("recorded" or "not recorded" as ODA): the ODA vs. OOF distinction in DAC statistics was artificial, also from the perspective of developing countries.
- LICs followed **IMF, not DAC, concessionality assessment practices**. This was because they were governed by the IMF Debt Limits Policy. This may be different for MICs, so further analysis on concessionality from the MICs' perspective should be carried out.

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## ANNEX

***Main points of discussions in sessions focused on the provider perspective***[4]

1. The **IMF** informed participants of the revision to their traditional assessment of concessionality in the context of the LIC DSF that was based on currency- and maturity-specific discount rates derived from the OECD's commercial interest reference rates (CIRRs).[5] The IMF and the WB had adopted in October 2013 a unified, fixed discount rate of 5%, set in reference to the 10-year average USD CIRR, with term premium added to reflect typically long maturities in lending to LICs. The objective of the reform was to unify the various discount rates used for various purposes and address operational problems inherent to variable discount rates: multiplicity of discount rates updated at different frequencies, absence of CIRRs for a number of currencies, unpredictable fluctuations in assessed concessionality of loans, steady decline in discount rates reducing the availability of loans meeting concessionality requirement. (The discount rates used so far also overestimated the present value of countries' debt stocks, thus hitting debt ceilings sooner and reducing the space for borrowing. In combination with the existing system of thresholds, they had also led to a questionably sharp borderline between concessional and non-concessional loans, while in reality lending instruments presented a continuum of terms. E.g. the difference in the calculated grant element of two loans with only one year difference in maturity but otherwise identical terms could be up to 16%.)

2. The decision to abandon currency-specific discount rates and use a 5% fixed rate was not based on a scientific but rather a very pragmatic approach to solve the operational problems. Moreover, the solution was temporary and would be reviewed periodically following the 3-year cycle of the DSF (next revision to take place in 2015) as it was important to retain a link to market conditions. The IMF stressed also that the current reform did not change the underlying concept of concessionality (measuring "fiscal effort" of the lender when lending below funding costs and burden-sharing among lenders), nor did it tackle the broader conceptual question of appropriate discount rate for debt sustainability analysis where further work was ongoing.[6]

3. **AFD** explained the construction of its concessional loans' interest rates. It used public resources provided by the French Government to either extend highly concessional loans or subsidise loans made from market-raised funds. In contrast to market rates, interest rates offered by the AFD did not include remuneration of risks (for sovereign loans) nor remuneration of capital (for both sovereign and non-sovereign loans) and could be further reduced through an interest rate subsidy. The absence of remuneration of capital and risk entailed actual costs for the French Government (e.g. it needed to pay for AFD capital increases).

4. AFD pointed out that the current measurement system of the DAC did not reflect the actual budgetary cost of loans: commitments overstated the donor effort and disbursements on a net basis were nil regardless of the effort. All loans with interest rates below market rates provided an advantage to the recipient and carried corresponding cost to the donor. Therefore, in one sense, borrower benefits equalled lender costs and could be identified through the concession "given" to the recipient country below what they would have paid on the market.

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4 For more details refer to the presentations for this section as well as the online IMF and DAC grant element calculators: http://www.imf.org/external/np/pdr/conc/calculator/ and http://www.oecd.org/dac/stats/methodology.htm.

5 The revision concerned lending to LICs only. The assessment of concessionality of lending to MICs was a separate issue and not discussed in the workshop. The AfDB highlighted however that it was using a fixed 6% discount rate for MICs.

6 For further details see http://www.imf.org/external/np/pp/eng/2013/100413.pdf.

5. **Development Initiatives** called for more rigorous ODA reporting. The grant element calculation should be based on more realistic reference rates and the statistics should better reflect the cash flow (i.e. take into account interest payments). Concessionality levels did matter from the perspective of recipients, but concessionality should be seen as a continuum rather than a "yes/no" measure (the current ODA/OOF distinction of development loans was artificial). This problem could be overcome by measuring the provider effort expressed as the grant equivalent of loans.

6. The **Export Credit Secretariat** explained that the rules in the OECD Arrangement on Officially supported Export Credits (provisions for Tied and Partially Untied Aid) aimed at limiting the use of subsidies to avoid trade distortion. Concessionality was looked at from the lender's perspective using the "differentiated discount rates". Tied aid was subject to minimum concessionality requirements but also country and project eligibility. The export credit community was concerned about the IMF/WB reform moving away from currency-specific discount rates, given that interest rate differentials might re-emerge, and thought that the anomalies described by the IMF could be overcome by other means.

7. The **DAC** Secretariat informed participants of the implementation of the DAC agreement on concessionality, valid for an interim period until 2015, which entailed the production of an annual report on ODA loans. The analysis of ODA loans committed in 2011 had shown that using different discount rates greatly affected the volume and number of loans assessed as concessional, and a more unified approach to defining concessionality could be considered. The possibility of quantifying concessionality through the loans' grant equivalents could be looked at in the process of developing a new measure of "total official support for development" and of possibly modernising the ODA concept.

8. Participants were interested in the history and rationales behind the choice of discount rates used in grant element calculations and concessionality thresholds applicable for different purposes. These were the result of political negotiations around burden sharing. Several participants thought that a more harmonised approach at the international level was desirable. However, it was pointed out that the risk exposure of bilateral and multilateral lenders differed (the latter benefiting from their preferred creditor status) and that the "donor effort" of multilateral flows was captured through reporting on core contributions to these agencies. Harmonizing approaches should also not lead to untied aid be submitted to the same requirements as tied aid in terms of minimum concessionality thresholds (currently higher for tied aid).

9. In DAC statistics, the grant element was originally defined in relation to donor costs and measured a **budgetary effort;** the flat 10% discount rate was determined in consideration of **opportunity costs** (incurred by diverting resources from domestic investment). The possibility of considering "concessionality in character" as a concept to be assessed against market conditions in developing countries was raised, but the IMF explained that the concept of concessionality historically referred to lenders' **funding costs** and implied a comparison with lenders' (not borrowers') market rates; the fact that multilaterals did not face any funding costs for their concessional windows was not considered a major impediment in this logic.

10. Participants discussed whether the discount rate was supposed to reflect lenders' cost of funding, opportunity costs or risk exposure. As regards the latter, some considered that the OECD Export Credit Group premia accurately reflected country risks and could be factored into the applied discount rate, while others thought that such a system would be impracticable. The Secretariat clarified that if a risk margin should be incorporated in the concessionality assessment, then the

present reporting on debt relief would need to be revised to avoid valorising the risk-taking twice.[7] It was also suggested that if there were to be no consensus to change the discount rate, raising the grant element threshold for ODA reporting should be considered. Placing too much emphasis on the interest rate was cautioned against (analysis of the net present value of loans shows the importance of long grace periods for developing countries). Other issues raised included whether debt sustainability should be an element of a reformulated definition of concessionality; whether a tighter definition of concessionality would mean fewer resources for the developing world, and whether it would result in fluctuations in the ODA levels.

11. Participants also discussed whether the discount rate should be applied (i) to rule a loan in or out of Official Development Assistance (ODA), or (ii) to calculate a "grant equivalent" of the loan to be recorded as ODA, with actual disbursements being counted as other official flows (OOF). The first alternative had the advantage of continuity with the present approach of measuring ODA on the basis of actual cash flows; the second would provide a more accurate comparison of donor effort and burden sharing, and remove the unrealistically sharp dividing line between loans that just qualify as ODA and those that just fail to qualify. Another alternative to account for loans in DAC statistics would be to only record the injection of the subsidy as ODA, as illustrated in the presentation by AFD; this would be in line with the current treatment of the subsidisation of multilateral flows (bilateral donors' subsidies to multilateral agencies are recorded as multilateral ODA) and of associated financing. In terms of burden sharing, it was felt that a fair assessment would need use a measure similar to grants so that donors only providing grants get full credit.

12. All in all, there did not seem to be a perfect discount rate: the IMF reform was for operational purposes only, and the IMF was still reflecting on the most appropriate discount rate to use. Therefore, one conclusion was that ODA measurement should not rely too much on the choice of the discount rate: the discount rate is debatable and should not be so important as to determine in a too strict way the ODA eligibility of a loan with the entire amount being counted in one case and in the other case nothing being counted at all (e.g. the IMF faced the situation where a loan was first considered concessional on the basis of the discount rate current at the time, but disqualified just a few months later when the discount rate was updated).

***Main points of discussions in sessions focused on the recipient perspective***

13. Mr. Paul Mudde moderated this session, asking partner country discussants (from Malawi, Mozambique and Uganda) to comment on the following specific questions on recipient assessment and benefit of concessional loans:

- Do you make a concessionality assessment on finance offered – and what is it?
- What are your considerations for using concessional vs. commercial finance? Is the distinction ODA/OOF/ export credit relevant from your perspective?
- Who is the ultimate obligor (debtor) – a sovereign (Finance Ministry/government) or non-sovereign entity?
- What are the differences in lending by OECD-DAC versus non-OECD-DAC providers?
- Recipient benefit vs. donor effort: what is important from your perspective?

[7] This suggestion had been advanced in a recent staff paper that presented a possible new measure of « official development effort »; see http://www.oecd-ilibrary.org/development/the-evolution-of-official-development-assistance_5k3v1dv3f024-en

14. Responses and insights, also reflecting questions and comments from the floor, were:

- All three partner country discussants said that their LIC status brought them within the Debt Sustainability Framework of the IMF and they assessed concessionality using the IMF methodology and 35% grant element threshold, and did not look at ODA criteria. The DAC category of loans (ODA, OOF, private market) is of little relevance for recipients, but knowledge and data on the inflows and outflows of all borrowing (captured in statistics on developing countries' resource receipts) are necessary and highly relevant.
- Softness of terms is a key consideration (the more favourable interest rates and the longer grace and repayment periods the better in principle), but not the only one. Highly concessional financing often entails lengthy preparation phases and heavy administrative burdens, so there are cases where even a commercial loan that provides fast financing (especially for projects with expectation of high returns) may be preferred. A suitable complementary mix of highly concessional, less concessional and commercial loans is seen as optimal.
- Overall, partner country discussants highlighted the need for highly concessional lending to LICs (the needs are "more than can be fulfilled") but also highlighted that these resources were limited in scope and that they needed to explore new options for financing. Raising funds on bond markets would be one option, but was observed as costly in cases where projects were not ready once resources were raised. Uganda stated that its current borrowing consisted of 90% concessional (primarily from the WB and AfDB) and 10% non-concessional finance.
- In most cases a sovereign entity is the ultimate obligor. When the government on-lends the funds to enterprises (which it often does), concessionality (subsidies/benefits received) is passed on to the project.
- On differences between lending from non-DAC vs. DAC donors, partner country discussants commented on issues such as value for money, tying status and procurement, but also here a suitable complementary mix was seen as useful. (Highly concessional lending from traditional donors was largely untied whereas less concessional/commercial lending was largely tied.)
- Three elements were seen as key when talking about "recipient benefit":
  1. Not only the **gain in financial terms by the offer from a loan provider vis-a-vis the market terms** (main focus in the providers' debate on concessionality so far), but also
  2. **Debt sustainability considerations** – a good balance needed to be established between removing financing constraints on the one hand and avoiding debt distress on the other; the IMF Debt Limits Policy put an explicit limit on non-concessional borrowing for countries having a programme with the IMF.
  3. Devotion, i.e. what project/undertaking the financing is used for, and quality aspects needed to be factored in. Examples of this explicitly mentioned were: Does the financing lead to asset-building? Are national/international standards being observed? What is the sustainability of the financed undertaking?

15. The three countries represented at the meeting were LICs and part of the IMF DSF; their external financing was governed by explicit debt limits on non-concessional financing. It would now be necessary to also appreciate the views of MICs on concessionality and its assessment.