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# Background paper: The treatment of loan concessionality in DAC statistics

To be recognised as concessional and reportable as ODA, a loan must according to the present reporting criteria have a grant element of at least 25%, calculated at a discount rate of 10%, and be "concessional in character". The latter criterion is not precisely defined in the Directives and, as such, there are different views on its interpretation among members. To remove this inconsistency, the 2012 DAC High Level Meeting (HLM) agreed *to establish, as soon as possible, and at the latest by 2015, a clear, quantitative definition of "concessional in character", in line with prevailing market conditions*.

In line with this mandate, the DAC has worked on options to revise the treatment of loan concessionality in DAC statistics, also taking into account the resource allocation, mobilisation and accountability objectives of the general reform of the system for measuring development finance post-2105. The revised system should:

- **provide a fairer picture of donor effort** (ensure comparability of resulting statistics across members);
- **be adapted to today's development co-operation** (be relevant to, and establish a level playing field among, the various instruments that make up the development finance toolbox);
- **ensure lending practices that are aligned with developing countries' needs, capacities and constraints in terms of volumes, concessionality levels and debt sustainability;**
- **strengthen the credibility and integrity of DAC statistics and transparency of development co-operation**.

## Why change the treatment of loan concessionality in DAC statistics?

There has been much criticism over the past decade that the **10% discount rate used in the calculation of the grant element is too high given the current global interest rate environment**, and it has become easy to lend at or above long-term bond rates, while still meeting the 25% grant element test. Consensus was not reached on earlier proposals to revise the discount rate (SLM 2003 and 2004).

As development finance has evolved over time, **variability in donor interpretations regarding the meaning of "concessional in character"** has led to reported figures not being endorsed by all the members, with regard to loans extended from funds raised on capital markets without any official sector explicit subsidy. To recognise that there are different views on the interpretation of "concessionality in character" among DAC members and pending the establishment of a quantitative definition, the DAC agreed in April 2013 on a temporary treatment of concessionality in DAC statistics for loans extended in 2011-14.

Loans are at present counted in DAC statistics on a cash-flow basis, as positive ODA when disbursed, and as negative ODA when repaid. Over time, the net ODA effect of the loan – if repaid – is therefore zero, but in times of inflation, the real value of the repayments is substantially lower than the face value of the loan. The present system "rewards" donors in times when their loan portfolios are increasing, and "penalises" them considerably later as and when loans are being repaid. Consequently, **ODA in any given year may be greatly influenced by the development co-operation policies of the past.**

Concessional loans have been an important part of ODA, actively used by a number of members, as well as by other providers of development assistance. In response to developing countries' increased financing needs, some members are scaling up their lending programmes. It is therefore crucial that the Reporting Directives are clarified at this point of time.

### Emerging principles for the treatment of loan concessionality in DAC statistics

Over the past two years, the DAC and its Working Party on Development Finance Statistics (WP-STAT) have discussed various options for establishing a quantitative definition of "concessional in character" that would comply with principles and decisions agreed at the 2012 HLM. From July 2014 onwards, political discussions on the options were taken forward by a "high-level working group on concessionality" so that a decision could be taken at the HLM in December 2014. Principles for revising the treatment of loan concessionality in DAC statistics that have emerged from this process include:

1. **Replacing the cash-flow based system with a grant equivalent system for the purpose of calculating the ODA headline figures**. Revising ODA accounting to measure budgetary effort – and to include only the grant equivalent (instead of the full face value) of non-grant instruments – would address the weaknesses of current DAC statistics by:
    - Providing for a more accurate assessment and comparison of donor effort and burden-sharing.
    - Creating a level playing field between grants and loans in ODA allocation and thereby encouraging the most efficient use of concessional resources, based on the recognition that the level of concessionality needs to take into account the recipient country's level of development and capacities as well as the nature of the project.
    - Providing a better indicator of development co-operation policies in any given year because the repayment of past loans would not lead to reduced amounts of ODA.[1]
2. **Assessing concessionality based on differentiated discount rates,** recognising that lending to poorer countries involves greater donor effort and recipient benefit than lending to richer countries. The underlying rationale here is that the donor effort in providing a loan consists both of the funding cost of the loan and the risk associated with it. The benefit to the recipient of the loan depends on the difference between the costs of the loan and the cost of alternative financing. The differentiated discount rates would therefore consist of a base factor reflecting the funding cost of the loan and a risk adjustment factor which will be defined by developing country group.

3. **Establishing thresholds on the level of grant element** to ensure that loans to low-income countries are provided at highly concessional terms and to prevent notions that ODA schemes follow a commercial logic.

4. **Avoiding creating major fluctuations in overall ODA levels.** Various simulations with the above parameters have indicated that a change from a cash flow to a grant equivalent system would not have, overall, a major impact on total ODA. However, the impact varies for individual donors. More specifically, the change would result in a seeming "decrease" of ODA for donors with an increasing loan portfolio and an "increase" of ODA for donors with a stable or decreasing loan portfolio. Such effects will be perceived in the short run, during the transition to the new system, but will disappear over time. In any case, continued collection and publication of data on the terms and conditions of individual loans will enable close monitoring of lending practices and analysing the impact of the change.

5. **Ensuring full transparency on actual ODA flows**, including for the stock of loans that have been reported as ODA in the existing system and that will remain outstanding by the time of the change. **Data on disbursements and repayments of loans would continue to be collected and published**, even though it is the grant equivalent of loans that would be accounted for in ODA. Changing the ODA measurement from net flows to risk-adjusted

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[1] The current system – counting loan disbursements minus repayments on earlier loans – can lead to: i) volatility in ODA levels, ii) a lack of correlation between the government's decision regarding the budgetary effort and the ODA volume generated the year the decision has been taken, and iii) artificially large outflows and inflows, especially in years of major debt forgiveness.

grant equivalents will also change the basis for reporting on debt relief of official loans. **Given that the new system would value upfront the risk of default on ODA loans, the eventual forgiveness of these loans would no longer be reportable as a new aid effort**.

### What can be expected and when?

- The **principles for revising the assessment of concessionality and reporting on ODA loans** are expected to be agreed at the DAC HLM in December 2014. This will be followed by WP-STAT work to prepare the **revised Reporting Directives** for endorsement by the DAC by the end of 2015.

**From cash flows to grant equivalents – illustration**