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# Private sector instruments: treatment of mezzanine finance instruments

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This note presents an initial proposal for the treatment of mezzanine finance instruments in DAC statistics, as part of the review of the provisional reporting methods for private sector instruments (PSI). Developed in line with the agreed 2016 HLM general principles for PSI, the proposal takes into account the outcomes of the Part 1 of the review in the first semester of 2022 and builds upon members' discussions and other activities in the context of the WP-STAT since September 2022. Informed by methodological considerations on loans to the private sector and equities, it puts forward considerations regarding ODA-eligibility rules, methods for calculating grant equivalents and related parameters, reporting requirements, rules for data disclosure and safeguards for senior equity and junior loans.

This paper is shared for **DISCUSSION** under item 4b of the draft annotated agenda [DCD/DAC/STAT/A(2023)1].

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# *Treatment of mezzanine finance instruments*

## 1. Background

1. Mezzanine finance instruments are currently not reportable as ODA, as per the provisional reporting methods for private sector instruments (PSI). This disincentivises their deployment and therefore limits donors' capacity to mobilise private finance for sustainable development. Moreover, it negatively affects the integrity of the DAC statistics due to the limited comparability of the reporting approaches. In the context of members' review of the provisional reporting methods, this paper addresses this anomaly in the DAC statistics and proposes recording the donor effort in extending mezzanine finance on a grant equivalent basis.[1]

2. This proposal has been developed in line with the 2016 HLM general principles for PSI[2], taking into account the outcomes of Part 1 of the review of the provisional reporting methods in Q1-2 of 2022 [DCD/DAC/STAT(2022)15 and DCD/DAC(2022)39/REV1]. It is also inspired by members' methodological discussions in the past[3] and during the PSI review to date.[4] It puts forward ODA-eligibility rules, methods and related parameters for calculating grant equivalents, reporting requirements, rules for data disclosure, safeguards and other considerations.

3. **Members are invited to comment on the proposal for the treatment of mezzanine finance instruments, in particular:**

- **The relevance of anchoring the methods to those developed for loans to the private sector and equities;**
- **The proposed values for the private sector surcharge;**
- **The implementation timeline;**
- **Possible priorities for members' upcoming discussions on the treatment of mezzanine finance instruments in the PSI project Team.**

4. **Moreover, members are invited to indicate their ability and willingness to provide case studies with financial details for analytical and simulation purposes.**

## 2. Scope

5. The existing directives define mezzanine finance as "instruments relating to the layer of financing between a company's senior debt and equity, with features of both debt and equity". They further specify that claims of mezzanine finance providers are subordinate to those by senior lenders but with benefits compared to junior equity investors.

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[1] Details on the approach for members' discussions in the context of the review Part 2 can be found in DCD/DAC/STAT(2022)29.

[2] See DAC-HLM-Communique-2016.pdf

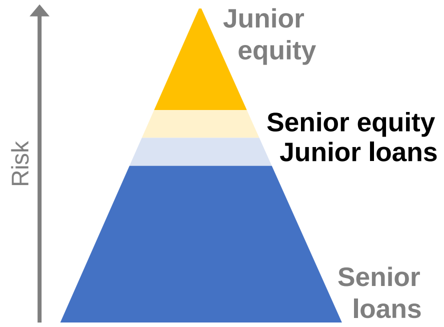
[3] See DCD/DAC/STAT(2016)2 and DCD/DAC(2017)18/REV1.

[4] The topics discussed under the first batch of members' review deliberations included the treatment of credit guarantees, treatment of loans to the private sector and the ODA-eligibility assessment.

There are two main types of mezzanine finance instruments: junior loans and senior equity (also see Figure 1).[5]

- Examples of junior loans include loans with voting rights or other benefits, shareholder loans and subordinated loans (these terms are not mutually exclusive). In general, junior loans have subordinate access to liquidity in the case of default compared to senior lenders.
- Examples of senior equity include preferred equity and, in the case of structured collective investment vehicles (CIVs), mezzanine/senior shares/units. Generally, in the event of default, owners of senior equity shares have access to liquidity that is subordinate to lenders but preferred to junior equity investors. Preferred equity holders have also preferred access to dividends compared to junior equity holders.

**Figure 1. Mezzanine finance instruments**




## 3. 2016 HLM Principles

6. The 2016 HLM principles do not explicitly mention mezzanine finance. However, the provisional reporting methods and members' past discussions recognise them as private sector instruments. Given the proximity of junior loans to (senior) loans to the private sector and senior equity to (junior) equity, this proposal considers the 2016 HLM principles as providing sufficient orientations for members' discussions on the treatment of mezzanine finance instruments.

7. In this context, principle xii of the 2016 HLM Communiqué state that

> *Loans are counted on a grant equivalent basis. The discount rate for the grant element calculation will be differentiated by income group as in the 2014 DAC HLM agreement, in principle with an additional risk premium (see principle v) reflecting the fact that lending to private sector entities is generally more risky than lending to the official sector. HLM follow-up: elaborate i) a proposal for the risk premium (the additional risk premium could vary by income group) and ii) a recommendation on whether loans to the private sector should be exempted from a threshold or whether a technical threshold should be set (see principle v).*

> *Equity investments by DFIs or other vehicles in private sector entities in developing countries are counted on a grant equivalent basis ex post, i.e. they are initially counted at face value and their reflows discounted ex post, upon exit. The reflows will be discounted using differentiated discount rates by income group, applying a cap on reflows*

[5] See Annex 10b of the Reporting Directives in DCD/DAC/STAT(2020)44/ADD1.

*corresponding to the original investment. In specific cases and where enough information is available to estimate the reflows and risk undertaken, measurement will be on a grant equivalent basis calculated ex ante, adjusted ex post. HLM follow-up: work with DFIs to determine the appropriate discount rates for this calculation.*

## 4. Eligibility

8. In line with the spirit of the HLM Communiqué and members' discussions to date as well as the general principles underpinning the DAC statistics, for mezzanine finance instruments to be ODA-eligible, they need to be

- Allocated to countries or territories on the DAC List of ODA Recipients;[6]
- Administered with the promotion of economic development and welfare of developing countries as their main objective;
- Additional financially, in value or both, combined with their development additionality;
- Of a maturity of more than one year.

## 5. Parameters and methods

9. Donor effort in extending mezzanine finance instruments is measured on a grant equivalent basis.

10. As regards the underlying calculation, junior loans are treated the same way as loans to the private sector [see DCD/DAC/STAT(2022)49/REV1] and senior equity the same way as equity [see DCD/DAC/STAT(2023)/3].

11. The discount rate architecture is composed of

- A base factor of 5% (IMF unified discount rate) representing the funding cost,
- A risk-adjustment factor differentiated by DAC income group (4% for LDCs and other LICs, 2% for LMICs and 1% for UMICs) representing country risk, and
- A private sector surcharge of 2% representing risks associated with extending mezzanine finance instruments to the private sector.[7]

12. The technical grant element threshold for mezzanine finance instruments is set to 0%, in line with the proposed treatment of equities [see DCD/DAC/STAT(2023)/3] and the treatment of loans to the private sector [see DCD/DAC/STAT(2022)49/REV1].

[6] This may also include mezzanine finance instruments invested in intermediaries, including CIVs, in donor and third countries, provided the main objective of the financing is the promotion of economic development and welfare of ODA Recipients, and relevant due diligence has been carried out by the PSI vehicle.

[7] The value of the private sector surcharge for mezzanine finance instruments is higher than that for loans to the private sector and lower than that for equities.

**Table 1. Discount rate architecture for mezzanine finance instruments**

| | LDCs and other LICs | LMICs | UMICs |
|---|---|---|---|
| Base factor | 5% | 5% | 5% |
| Risk-adjustment factor | 4% | 2% | 1% |
| Private sector surcharge | 2% | 2% | 2% |
| **Discount rate** | **11%** | **9%** | **8%** |

## 6. Reporting requirements, data disclosure and safeguards

13. For junior loans, reporting requirements, rules for data disclosure and safeguards are identical to those for loans to the private sector [see DCD/DAC/STAT(2022)49/REV1]. For senior equity, they are identical to those for equities [see DCD/DAC/STAT(2023)/3].

## 7. Other considerations

14. To facilitate members' reporting and in the interest of transparency and monitoring, the Secretariat will review and, if need be, refine the list of financial instruments concerning equity investments in Annex 10b of the Reporting Directives; [DCD/DAC/STAT(2020)44/ADD1], for example to enable reporting on mezzanine/senior shares/units in CIVs.

15. Comparability is a key feature of the DAC statistics. Discussions on mechanisms for monitoring the comparability of the instrument and institutional approaches will be discussed at a later stage of the Part 2 of the review process under step 4 on monitoring, safeguards and disciplines [see DCD/DAC/STAT(2022)15 and DCD/DAC/STAT(2022)29].

## 8. Implementation

16. Reporting on the donor effort in extending mezzanine finance instruments on a grant equivalent basis will be implemented as from members' 2024 reporting on flows in 2023. Members that are unable to implement these reporting methods in 2024 may use a transition period of one year during which the provisional reporting methods would continue to apply as regards ODA accounting and data disclosure.[8]

[8] Paragraph 9D of DCD/DAC/STAT(2020)44/ADD3 states that "due to the lack of agreement on the details of accounting for ODA eligibility of mezzanine finance and guarantees, such instruments would not be included in ODA (...)."