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**Development Co-operation Directorate**
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## DAC Working Party on Development Finance Statistics

# PROPOSAL FOR CLARIFICATION OF CONCESSIONAL IN CHARACTER

**Note by Canada, France, Germany and Spain**

**16 October 2012, OECD Conference Centre, Paris**



*This proposed clarification of "concessional in character" is presented by Canada, France, Germany and Spain. It follows up on the discussion of the concept of "concessionality in character" in a Task Team of the Working Party on Development Finance Statistics on 14 September 2012. It is presented for DISCUSSION at the meeting of the full Working Party on 16 October 2012.*

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**PROPOSAL FOR CLARIFICATION OF CONCESSIONAL IN CHARACTER**

1. This proposal puts forth a qualitative clarification of concessionality in character. The proposed approach is that concessionality of financing should be evaluated relative to financing otherwise available to the borrower – this approach being more relevant because it takes into consideration partner countries' economic context and genuine opportunities. This is also the prevailing approach by other bodies engaged in development-related financing such as export credit agencies and the WTO. To count as ODA, the financing instrument must also pass the 25% grant element test (at 10% discount rate) as per the current practice.

2. One major component is for the lender to evaluate opportunity cost and investment risk of the borrower. While there is no one universal approach to evaluating these factors, the world's leading lending agencies use a variety of factors generally specific to the recipient country.

3. The reality is that the market rate of a country depends on multiple factors such as maturity, grace period, credit worthiness/rating, collateral and currency. No single market rate for all borrowers exists. Even for one specific borrower, various market rates may exist depending on maturity, currency and other factors.

4. Generally, a loan is below the market rate if a donor provides it at a rate lower than another entity with commercial interests given similar conditions (duration, collateral). To prove this, a loan should be compared with other financing alternatives of the borrower. As every borrower is different (sovereign and non-sovereign), the point of comparison is also different for each one, which necessitates a case-by-case approach rather than an all-encompassing one. As a point of comparison we would like to propose the bond rates of the borrowing country (or if not available, those of equivalently rated countries).

5. An example of using bond rates in the loan currency is included under Annex A. This example shows that the "risk premium" is highly significant in the market condition of the borrower and may represent several times the donor's initial bond yield from which the CIRR and the DDR are computed.

6. If no point of comparison is available at all, because a country does not have access to the capital market and there is barely anyone else willing to give the country loans with maturities as long as the donor is willing to offer, we could conclude that there is no prevailing market rate and therefore anything the donor offers is concessional in character as long as it contains a grant element of at least 25%. This argument is based on the assumption that the country has no alternative way of funding apart from the donor's loan and could otherwise not realize development projects.

7. The advantage of this approach is that it cures the most severe shortcoming of the DDR which is the lack of acknowledgement of individual country risks. While some donors may operate on lending at DDR rates, these rates are often far less than those required to meet the 25% grant element condition. Therefore, adopting the DDR approach to concessionality in character would in fact disqualify some loans from their current ODA status as it would be the more stringent condition than the notion traditionally used by many donors.

8. In addition, setting a more stringent test for concessionality would effectively push donors away from loan operations in higher risk countries or with non-sovereign counterparts that possess both development needs as well as payment capacities (e.g., categories 6 and 7 of the OECD country risk classification that comprise of over half of the developing countries).

9. In terms of private sector lending, concessionality must be adaptable to new financing mechanisms developed to support and engage the private sector within the development arena. For example, the concept of "minimal concessionality", which applies when dealing with private sector lending, where donors try to facilitate desirable development activities that would otherwise not have been undertaken because of low profitability or high financial risks. Donors step in to provide support for such projects, but once the profitability threshold is reached, there is no need to provide additional concessionality. Flows beyond the minimal threshold required to catalyze a project would generally flow directly to private investors without further development impact, which is not the intention of development assistance.

10. A second aspect that should be taken into consideration is that fixating on concessional interest rates may also cause distortions to the private market whereas concessionality through significantly longer maturity or grace periods would have less negative impact.

11. The following clarification of concessional in character is therefore proposed:

**Concessional in Character**
Concessionality of financing is determined based on the benefit to the borrower. An investment, a loan, or financing is considered "concessional in character" if it provides benefit relative to the recipient's best market-based source of financing. Benefit may be determined on the basis of an investment's price (interest rate), maturity, grace period, tenor, and/or repayment structure.
Financing may also be considered concessional if offered at terms that are beneficial to the borrower and are not available from other sources based on the borrower's access to financing.

**Local currency financing**
Donors engaged in local currency financing may use IMF data on lending rates to evaluate the concessionality of local currency financing instruments. Donors are required to distinguish between bank and non-bank entities as follows:
a. Lending to banks: interest rates below the discount rate offered by the country's central bank are considered concessional.
b. Lending to non-banks: interest rates below the lending rate offered to prime customers are considered concessional.
The rates for both discount and lending are available by country through the IMF/IFS Economic Indicators online database:
http://elibrary-data.imf.org/DataReport.aspx?c=1449311&d=33061&e=169393.

**Reporting Guidelines**
Concessionality and the benefit to the borrower must be clearly noticeable and articulated when reporting to the OECD. The donor must provide the complete inventory of loan information (interest rate, maturity, grace period, repayment terms) required for comparison to the borrower's best market-based source of financing (which also has to be provided as reference) so that the benefit to the borrower is clearly established.
Due to confidentiality and competitive market considerations, donors may wish to provide their disclosure in confidence to the DAC and other donors. The OECD would not make that information publicly available.

## ANNEX

The model below is used as an illustration of the computation of borrower's interest rates using country risk premiums by using a comparison of bond yields.

The concept of a country risk premium refers to an increment in interest rates that would have to be paid for loans and investment projects in a particular country compared to some standard. One way of establishing the country risk premium for a country is to compare the interest rate that the market establishes for a standard security of the borrower, say central government debt, to the comparable security in the benchmark country, normally an AAA credit rating donor. Both securities must be comparable in terms of maturity and currency.

For example, suppose the donor government has a currently issued ten-year euro bond that has a yield to maturity of 5 percent and the government of a recipient borrows euros by selling a ten-year bond that pays in euros and the yield to maturity of that bond is 7 percent. The country risk premium the recipient is the difference, in this case 2 percent (or 200 basis points).

Using this analysis, the following table has been populated based on the risk premium (called default spreads) by credit rating class (rough average of countries in the same rating). These have been mapped to the OECD's country risk categories (see http://www.oecd.org/tad/exportcredits/cre-crc-current-internet-rev1.pdf) to simplify their use:

<table>
<tr><th>Credit Rating (moody's)</th><th>Default spread (basis points)*</th><th>OECD country risk category</th><th>Average default spread per risk category (bps)</th></tr>
<tr><td>Aaa</td><td>0</td><td></td><td></td></tr>
<tr><td>Aa1</td><td>25</td><td></td><td></td></tr>
<tr><td>Aa2</td><td>50</td><td></td><td></td></tr>
<tr><td>Aa3</td><td>70</td><td></td><td></td></tr>
<tr><td>A1</td><td>85</td><td>1</td><td rowspan="3">100 (= 1.00%)</td></tr>
<tr><td>A2</td><td>100</td><td>1</td></tr>
<tr><td>A3</td><td>115</td><td>1</td></tr>
<tr><td>Baa1</td><td>150</td><td>2</td><td rowspan="3">175 (= 1.75%)</td></tr>
<tr><td>Baa2</td><td>175</td><td>2</td></tr>
<tr><td>Baa3</td><td>200</td><td>2</td></tr>
<tr><td>Ba1</td><td>240</td><td>3</td><td rowspan="2">258 (= 2.58%)</td></tr>
<tr><td>Ba2</td><td>275</td><td>3</td></tr>
<tr><td>Ba3</td><td>325</td><td>4</td><td>325 (= 3.25%)</td></tr>
<tr><td>B1</td><td>400</td><td>5</td><td>400 (= 4.00%)</td></tr>
<tr><td>B2</td><td>500</td><td>6</td><td>500 (= 5.00%)</td></tr>
<tr><td>B3</td><td>600</td><td>7**</td><td>600 (= 6.00%)</td></tr>
<tr><td>Caa1</td><td>700</td><td>7</td><td rowspan="3">850 (= 8.50%)</td></tr>
<tr><td>Caa2</td><td>850</td><td>7</td></tr>
<tr><td>Caa3</td><td>1000</td><td>7</td></tr>
</table>

* source: Aswath Damodaran Jan 2011
** an 8th category is added here to account for spread between B3 and CAA categories. Countries in OECD risk category 7 that do not have a credit rating of B3 would be subsumed under CAA rating

The model then is as follows:

1- First, start with the bond yield in the loan currency (EUR in this example) as that reflects the refinancing cost of the donor.
2- To that, add the risk premiums to reflect the investment risk.
3- To cover the additional cost of the credit, add a cost of credit margin of 100 basis points (similar in approach to the CIRR).

| Maturity (years) | 5 | 10 | 15 | 20 | 25 | 30 |
|---|---|---|---|---|---|---|
| bond yield (EUR)* | 0.774 | 1.959 | 2.561 | 2.72 | 2.662 | 2.524 |
| Cost of credit | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| **Risk Category** | **Interest rates including risk premium by category (%)** | | | | | |
| **1** | 2.77 | 3.96 | 4.56 | 4.72 | 4.66 | 4.52 |
| **2** | 3.52 | 4.71 | 5.31 | 5.47 | 5.41 | 5.27 |
| **3** | 4.35 | 5.53 | 6.14 | 6.30 | 6.24 | 6.10 |
| **4** | 5.02 | 6.21 | 6.81 | 6.97 | 6.91 | 6.77 |
| **5** | 5.77 | 6.96 | 7.56 | 7.72 | 7.66 | 7.52 |
| **6** | 6.77 | 7.96 | 8.56 | 8.72 | 8.66 | 8.52 |
| **7**** | 7.77 | 8.96 | 9.56 | 9.72 | 9.66 | 9.52 |
| **7** | 10.27 | 11.46 | 12.06 | 12.22 | 12.16 | 12.02 |

* as of 2012-09-28, source: http://www.ecb.int/stats/money/yc/html/index.en.html
** see explanation of this category in the table above

The resulting table provides an approximate benchmark that can be used to evaluate interest rates as per the OECD country risk categories. While this approach provides an indication of interest rates it does so by category and therefore misses finer elements of financing to particular countries or non-sovereign counterparts.

The chart below compares rates calculated above with those required to meet the 25% grant element condition. It is clear from the chart that in most instances, the 25% grant element condition requires interest rates far below those with risk premium; hence, the 25% grant element plays the role of a ceiling to interest rates ensuring concessionality.