Organisation for Economic Co-operation and Development

DCD/DAC/STAT(2023)3

Unclassified

English - Or. English

9 March 2023

Development Co-operation Directorate
Development Assistance Committee

DAC Working Party on Development Finance Statistics

Private sector instruments: treatment of equities

Working Party on Development Finance Statistics, 21-23 March 2023, Paris

This note presents an initial proposal for the treatment of equities 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 and past work on their implementation, 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. It puts forward ODA-eligibility rules, methods for calculating grant equivalents and related parameters, reporting requirements, rules for data disclosure as well as ODA-integrity safeguards and other considerations.

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

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JT03513955

Treatment of equities

1. Background

1. The provisional reporting methods for private sector instruments (PSI) put forward a cash-flow basis for the measurement of donor effort in extending equities, applying a cap on sales upon exit to avoid negative net ODA. This temporary arrangement introduced hybrid accounting in ODA (mixing grant equivalents and cash flows), and within cash-flow accounting, the rationale for using a cap remains ambiguous. Neither do the provisional methods provide clarity on the ODA eligibility of the various types of equities and some other ambiguities. This paper addresses these limitations and proposes recording the donor effort in extending equities 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. 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 equities, in particular:**

- **The calculation methods for measuring donor effort and the suggested discount rate architecture;**
- **Reporting requirements, rules for data disclosure and safeguards;**
- **The implementation timeline;**
- **Possible priorities for members' upcoming discussions on the treatment of equities in the PSI project Team.**

2. 2016 HLM Principles

4. The general principle xii. of the 2016 HLM Communiqué states that

> *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 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.*

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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.

5. Moreover, the general principle iv. and the fourth paragraph of the principle xii. consider equity investment in DFIs or other PSI vehicles.[4] These have been addressed in the context of the ODA-eligibility assessment of members' PSI vehicles [see DCD/DAC/STAT(2023)51/REV2] and are therefore not covered by the treatment of equities presented in this document.

3. Scope

6. This methodological paper covers:[5]

- Common equity, such as investment in junior shares of enterprises;
- Common shares/units in collective investment vehicles (CIVs) with a flat structure and junior shares in structured CIVs, such as first-loss shares.

4. Eligibility

7. In the spirit of the HLM Communiqué and members' discussions to date as well as the general principles underpinning the DAC statistics, for equities 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 method

8. Donor effort in extending individual equity investments (see also paragraph 5) is measured on a grant equivalent basis. The challenge in calculating the grant equivalent of an equity investment is the uncertainty in relation to its actual returns and maturity. Taking into account these specificities, the 2016 HLM Principles put forward two methods for calculating grant equivalents of equities extended by PSI vehicles: ex ante and ex post, depending on the information available at the time of commitment.

[4] "(…) equity investment in a DFI or other vehicle is treated as a sunk cost, initially counted in ODA at face value (applying an ODA coefficient if need be – see principle x), with reflows, if any, counted as negative ODA."

[5] The treatment of senior equity investments, such as preferred equity and mezzanine/senior shares/units in structured CIVs, is addressed in DCD/DAC/STAT(2023)4.

[6] This may also include equities 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.

5.1. Ex-ante method

9. In specific cases and provided solid information is available to estimate reflows and risk undertaken, the grant equivalent is calculated ex ante as equity investment (gross disbursement) multiplied by a grant element.

10. The grant element is calculated using the formula for loans with an equal principal payment schedule (EPP), based on

- Expected maturity i.e. interval between equity commitment and sale (instead of loan maturity and grace period);
- Expected return i.e. dividends expected to be received per annum expressed as a percentage of initial investment (instead of loan interest rate).

11. Accordingly, the lower the expected return and the longer the expected maturity, the higher the grant equivalent.

12. Upon exit when the equity stakes are sold, the initially reported grant equivalent is adjusted ex post. Such an adjustment is recorded for the reporting year of the equity sale, calculated as a difference between the ex-ante estimates and amounts calculated using the ex-post method (see section 5.2 and Annex for an illustrative example).[7]

5.2. Ex-post method

13. Commitments and subsequent disbursements of equities are reported in ODA at face value at the time they occur. The reflows i.e. the actual receipts on equity sales and dividends give rise to a negative entry in ODA, counted with a discount (see Annex for an illustrative example).

14. A cap amounting to the value of the initial investment is applied to the cumulative discounted reflows. This is needed to ensure that donor effort remains positive or neutral (≥ 0) over the lifetime of individual equity investments.

15. Accordingly, the greater the loss, the higher the grant equivalent. If the cumulative value of the discounted reflows equals or exceeds the initial equity investment, donor effort over time is neutral (none).

5.3. Discount rate architecture and thresholds

16. For both methods, the discount rates are 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

[7] Accordingly, a positive value is recorded if the ex-post verification shows greater effort than expected ex ante. A negative value is recorded if the ex-post verification suggests a smaller effort than initially expected, applying a cap (see paragraph 14).

- A private sector surcharge of 3% representing the risks associated with investing equity in private sector institutions.[8]

17. The technical grant element threshold for equities is set to 0% as a means of acknowledging the limited relevance of concessionality thresholds for PSI. This is also in line with the application of a cap on reflows.

Table 1. Discount rate architecture for equities

	LDCs and other LICs	LMICs	UMICs
Base factor	5%	5%	5%
Risk-adjustment factor	4%	2%	1%
Private sector surcharge	3%	3%	3%
Discount rate	**12%**	**10%**	**9%**

6. Reporting requirements and data disclosure

6.1. Reporting requirements

18. In the interest of transparency and comparability, reporting requirements and data disclosure rules on equities are identical under both the instrument and institutional approach. In particular, the grant equivalents of individual equities are also reportable, for memorandum, by members applying the institutional approach (see principle xiii). In their case, the grant equivalent calculation is required to maintain the possibility of comparing ODA figures across members following different reporting approaches.

19. To be able to calculate donor effort in extending equities using either method outlined in section 5, the following data are required or particularly important in members' CRS reporting:

- Commitment date,
- Date of expected maturity (equity sale) for the ex-ante method,
- Expected return (dividends) per annum for the ex-ante method,
- Equity investment (gross disbursement),
- Dividends received per annum,
- Equity sale upon exit (amount received, prior to the application of a cap).

20. All these data items will be integrated in the CRS reporting template, making use of existing data fields to the extent possible.

21. Reporting on additionality is required too.

22. To allow for the verification by the Secretariat of the grant equivalent calculation for equities, each equity investment must be reported with a single CRS Id number and donor project number over its lifetime. Due attention must be paid to reporting correct commitment dates too.

[8] See definition of official and private in paragraph 15 of the Reporting Directives [DCD/DAC/STAT(2020)44].

6.2. Data disclosure

23. In response to growing transparency needs, yet keeping in mind commercial sensitivities and potential legal restrictions related to engaging with the private sector, there would be no restriction to data disclosure with the exception of expected dividends/return per annum and dividends in arrears, using either reporting approach. Both data items would not be disclosed.[9] Moreover, data on received dividends would only be disclosed aggregated by donor, agency, type of finance and recipient.

24. Channels of delivery (investees), disbursements, sales, expected maturities (if provided), grant elements (if applicable) and grant equivalents would be disclosed at activity level too.

7. Safeguards

25. The name of investee (e.g. enterprise or collective investment vehicle) is reported through the CRS field for channel of delivery.

26. For equities invested in intermediaries, including CIVs, in donor or third countries, the residence of such intermediaries will be reported in the description field of members' activity-level CRS reporting. A comprehensive explanation of the choice of such channels will be provided through the CRS fields on development objective and additionality.

27. To foster transparency, members will report full amounts of equity sales upon exit in the CRS field on amounts received as well as dividends received per year. The cap will only be applicable to the CRS field on grant equivalent.

28. To address members' concerns about the ODA integrity and effectiveness in the context of PSI, the DAC Secretariat will carry out biennially a thorough analysis of the geographic, recipient income group, sectoral and thematic characteristics as well as additionality of all PSI, including equities, reported in ODA under both the instrument and institutional approaches.

29. Findings from this analysis will be presented to the DAC in a dedicated report for information. Potential issues identified through this exercise will be addressed as part of subsequent DAC discussions.

30. The WP-STAT will use the outcomes of this analysis to review and, if agreed, revise relevant aspects of the directives on the treatment of equities to the private sector.

8. Other considerations

31. 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].

[9] Rules on data disclosure on the amounts mobilised are presented in paragraph 229 of the DAC Reporting Directives and are not affected by this proposal.

9. Implementation

32. Reporting on the donor effort in extending equities on a grant equivalent basis would be implemented as from members' 2024 reporting on flows in 2023. Members that are unable to implement these reporting methods in 2024 may use of a transition period of one year during which the provisional reporting methods would continue to apply as regards ODA accounting and data disclosure.[10]

[10] Paragraph 9C of DCD/DAC/STAT(2020)44/ADD3 states that "individual equity investments to private sector entities in developing countries will continue to be reported on a cash-flow basis:

- Positive ODA would be recorded at the time of investment and the proceeds of sales would be reportable as negative ODA applying a cap on reflows corresponding to the original investment. To be ODA-eligible, equities need to comply with the ODA definition i.e. have the economic development and welfare of developing countries as their primary purpose and be in line with Reporting Directives [see in particular paragraph 134 of DCD/DAC/STAT(2020)44].
- Contributions to investment funds may be ODA-eligible if in accordance with the existing Directives [see in particular paragraph 135 of DCD/DAC/STAT(2020)44]."

Annex: illustrative examples

In 2020, a DFI made an equity investment of USD 20 million to a company in an LDC, with an expected return of 7% per year and expected maturity of 5 years. The provider indeed exited in 2025, selling the equity stake for USD 22 million. Dividends received amounted to around USD 1.4 million per year on average (annual return of 7% on the initial investment).

Using the ex-ante method, the grant equivalents would be calculated as follows:

Table 2. Illustration of the ex-ante method

Period	Year	Investment	**Sale** (ex ante)	**Expected return** (dividend rate)	Dividends received	Total reflows	**Discount factor** (discount rate = 12%)	Present value of future reflows
0	2020	20.00						
1	2021	20.00		7%	1.40	1.40	1.12	1.25
2	2022	20.00		7%	1.40	1.40	1.25	1.12
3	2023	20.00		7%	1.40	1.40	1.40	1.00
4	2024	20.00		7%	1.40	1.40	1.57	0.89
5	2025	20.00	20.00	7%	1.40	21.40	1.76	12.14

Reporting year 2020	Sum of present value of future payments	16.40
	Grant element	18.02
	Grant equivalent in 2020	**3.60**
2025 ex-post adjustment, see Table below	**Adjustment**	**-1.06**
	Updated sum of grant equivalents over equity lifetime	**2.54**
	Updated grant element	**12.71%**

Using the ex-post method, the grant equivalents would be calculated as follows:

Table 3. Illustration of the ex-post method

Reporting year	**Investment** (disbursement)	**Sale** (received)	Dividends received	Total reflows	**Discount factor** (discount rate = 12%)	Discounted reflows	Grant equivalent
2020	20.00						20.00
2021			1.10	1.10	1.12	0.98	- 0.98
2022			1.30	1.30	1.25	1.04	- 1.04
2023			1.20	1.20	1.40	0.85	- 0.85
2024			1.70	1.70	1.57	1.08	- 1.08
2025		22.00	1.80	23.8	1.76	13.50	- 13.50

Sum of grant equivalents over the equity lifetime	**2.54**
Derived grant element	**12.71%**