



The CDFS Short Read – November 2022

ODA, PSI, Incentives, and Why they Matter



This CDFS Short Read in Brief

Numbers have a stubborn tendency to develop a life of their own. Measurements morph into targets, targets turn into ceilings, ceilings inevitably lead to optimisation, and the dynamics of optimisation create incentives. Incentives have real life consequences. The modernisation of the DAC Statistical System and the rules it sets for ODA reporting have far reaching implications for development finance.

0.7%
ODA/GNI

ODA has become core to the development debate, the intersection between politics and development and the visualisation of the scale and limits donor countries' generosity. As such the method through which it is calculated is of crucial importance.

1

The modernisation of the DAC Statistical System will create incentives for the use of different instruments within the development finance system, the implications of which must be understood.

2

As the focus shifts to financial instruments, the donor effort is linked to risk exposure rather than cash. There exists an opportunity to build on existing frameworks to develop a Risk Based Statistical System



DAC members did in 2012 embark on a modernisation of the statistical system used to measure and report ODA. This process was necessary to recognise the very real donor effort associated with lending to ODA eligible countries at concessional rates of interest, but also to increasingly consider the private sector instruments ('PSI') deployed to accelerate sustainable development.

The grant equivalent¹ method adopted by DAC members provides for a sensible approach to translating the donor effort linked to the concessionality of sovereign loans into a present-day cash figure.

The adoption of a set of fixed discount rates linked to income groups rather than observable market rates does however risk creating incentives that could prove counter-productive to DAC members' objectives.

The plot thickens where PSI are concerned. In their 2016 communique, DAC members clearly stated that these should not offer concessionality lest they distort markets but insisted that the higher risk exposure they take on to deliver additionality should be recognised as donor effort. One could be forgiven for thinking that a grant equivalent method originally created to acknowledge concessionality cannot therefore be directly transposed to a context where there can be none.

Additional complexity stems from the range of PSI utilised by donors and their PSI vehicles. The relative treatment of these instruments creates incentives and disincentives for their respective use.

In the event, a consensus around private sector risk premia to be added to the income-group based set of fixed discount rates could not be achieved. The inadequacy of the cash-flow based provisional method means an eventual agreement is urgently needed.

The calibration of the system is key and notwithstanding the path they choose, a transition period, during which data is compiled and analysed, allowing for the system to be finetuned should be agreed upon.

DAC members could choose to recognise risk as the correct nature and measure of donor effort where financial instruments are the mode of ODA delivery. As negotiations continue, they have the opportunity to build a risk-based statistical system. This would recognise the relative donor effort associated with financial instruments and acknowledge the higher level of donor effort inherent to grants. Where for example a loan and a guarantee create a similar credit risk exposure for a donor, they should not be assigned widely diverging ODA values lest they create differentiated incentives. Any incentives will in turn be reinforced or countered by regulatory frameworks some of their PSI vehicles are subjected to.

Arriving at a calibration that is neutral across instruments on a risk-adjusted basis needs not and should not result in ODA inflation detrimental to grant volumes.

For capital markets practitioners, this in turn brings into question the advisability of seeking to create such a system *ex-nihilo*, when much could be learnt from the reporting, regulatory and prudential frameworks, ranging from IFRS to Basel and Solvency, built over decades to regiment an increasingly financialised economy.

By leveraging off the considerable body of work they themselves commissioned, DAC members would not only efficiently arrive at a set of rules capable of accurately recognising risk-based donor effort and a resulting set of incentives aligned with the objectives they set, but they would in addition create a statistical system coherent with the wider financial system they increasingly seek to mobilise.

¹[https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DEV/DOC/WKP\(2017\)5&docLanguage=En](https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DEV/DOC/WKP(2017)5&docLanguage=En)



Preamble

The Development Assistance Committee's ('DAC') statistical system was designed to measure Overseas Development Assistance ('ODA') to help assess the magnitude of its donor countries' aid to developing nations. The measure turned into the language used by governments to express the ambitions, but at times also implicitly the limits, of their aid expenditure. Formulated around the 1969 DAC definition of ODA and proposed by the Pearson Commission in the same year, the 0.7% ODA/Gross National Income target for government expenditure has been a feature of the development conversation ever since².

The more recent drive to measure the donors' 'effort' associated with the use of financial instruments rather than grants, legitimately seeking to recognise the role of development finance, has created a need for a set of calculation rules to assign an ODA value to a range of interventions.

In a system where governments must contend with budgetary pressures, and development finance institutions, bilateral and multilateral, must reckon with a varying combination of regulatory frameworks, credit rating considerations and balance sheet limitations, an inadequate calibration of ODA calculation rules risks creating differentiated incentives for the use of specific instruments.

Imagined as a nesting doll, ODA requires sequential allocation decisions between grants and financial instruments, between

public sector lending and private sector instruments ('PSI'), and within the PSI component itself between different instruments ranging from equity investments to loans and guarantees of various descriptions, that at the very least risk being influenced by their respective ODA 'rewards'.

Financial institutions are shaped by rules-based frameworks, whether they be prudential or regulatory. Development focussed financial institutions are no exception. Specific governance arrangements will determine the order of priority of each competing set of rules they are subjected to. Ultimately however, it is reasonable to anticipate that portfolios of instruments will be optimised in the context of ODA objectives. This will in turn have a significant impact on the attention paid to the private capital mobilisation agenda.

The debate around the modernisation of the DAC statistical system is therefore arguably the most important conversation the development finance sector is currently having and deserves attention and input from a much wider set of its stakeholders than it is currently receiving.

The purpose of this CDFS Short Read is to highlight the system of incentives that it will potentially result in, to discuss the consequences this would have for private capital mobilisation dynamics, and to assess the potential to leverage off existing frameworks to build an integrated risk-based statistical system.

² <https://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/ODA-history-of-the-0-7-target.pdf>



1. The Story Thus Far...

Whilst this Short Read is focussed on the specific implications of the modernisation process for PSI dynamics, it is useful to provide some context.

This chapter of the ODA story opened in 2012, when the OECD DAC decided to begin work to establish how its statistical system could be modernised to take into account the changing realities of the development world, as well as to improve the quality of its output.

It was not long before it was decided that their labour should focus on financial instruments. In the final communique published further to their High-Level Meeting of December 2014, DAC members proclaimed:

“We therefore agree to modernise the reporting of concessional loans to make it easier to compare the effort involved with that in providing grants, by introducing a grant equivalent system for the purpose of calculating ODA figures”

and

“We agree to urgently undertake further work to reflect in ODA the effort of the official sector in catalysing private sector investment in effective development.”³

The year 2014 did indeed witness a significant development where loans extended to ODA eligible sovereigns were concerned. They were hitherto subjected to a concessionality test which made use of a fixed 10% discount rate to calculate a ‘grant equivalent’, which, expressed as a percentage of the loan’s face value delivered the ‘grant element’. Where this grant element exceeded 25% of the original amount of the loan, the loan was deemed concessional, and its full-face value would be added to gross ODA for the year in which it was extended. Loan repayments or principal when they were

received would be subtracted, thereby yielding a net ODA figure. Interest rate payments were simply ignored. This single hurdle-based test did result in loans qualifying for ODA inclusion to be equally valued in ODA terms, notwithstanding their interest rates, repayment terms and length. All ODA loans, once repaid, yielded exactly zero net ODA.

In 2014, the DAC agreed that a ‘grant equivalent’ method should replace the previously favoured cash flow-based system with a single calculation of the grant equivalent at the outset, using a base discount rate of 5% to which a risk premium of 1-4% was added depending on country income group. Minimum grant element thresholds were also put in place for recipient countries depending on their income category. This ensured, inter alia, that ‘more concessional loans’ would ‘earn greater ODA credit than less concessional loans’⁴. It also meant that these loans no longer resulted in net zero ODA once fully repaid.

Both the grant element and the grant equivalent concepts will be discussed in more detail in the next section, for they in turn were introduced into the PSI conversation.

This took place in 2016 when another High-Level Meeting held that February yielded eleven principles and a series of proposed calculation methods⁵, which will be discussed in more detail in Section 3. The principles included a couple of extremely important points. DAC members stated that “PSI are non-concessional in nature”, which meant the concessionality thresholds applied to sovereign loans since 2014 could not be used lest they encouraged subsidisation. They also

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<https://www.oecd.org/dac/OECD%20DAC%20HLM%20Communique.pdf>

4

<https://www.oecd.org/dac/OECD%20DAC%20HLM%20Communique.pdf>

5 <https://www.oecd.org/dac/DAC-HLM-Communique-2016.pdf>



observed that “financing the private sector is generally riskier than the official sector”, and that a risk premium should therefore be added to any discount rate utilised for sovereign loans to recognise the additional donor effort.

Concurrently published calculation methods then proceeded, where PSI loans were concerned, to explain that the same grant equivalent methodology should be adopted, albeit with a private sector risk premium added to the income group differentiated discount rates agreed upon in 2014. The definition of

these risk premia and the putative exemption from thresholds was left for future discussions. These, as will be seen, did not go to plan.

It was suggested that the ODA eligibility of PSIs could not be linked to concessionality but would instead be determined by the investees’ country ODA eligibility and the PSI’s additionality, defined as a combination of financial or value additionality and development additionality, as described in Box 1.

Box 1: Additionality

‘In the context of reporting on PSI in DAC statistics, an official transaction is considered additional either because of its “financial additionality” or “value additionality”, combined with its “development additionality”. Such a transaction is financially additional if it is extended to an entity which cannot obtain finance from the private capital markets (local or international) with similar terms or quantities and for similar developmental purposes without official support, or if it mobilises investment from the private sector that would not have otherwise invested. It is additional in value if the official sector offers to recipient entities or mobilises, alongside its investment, non-financial value that the private sector is not offering and which will lead to better development outcomes, e.g. by providing or catalysing knowledge and expertise, promoting social or environmental standards or fostering good corporate governance. It conveys development additionality if the development impact of the investment would not have occurred without the partnership between the official and the private sector.’

Source :

[https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC\(2018\)47/FINAL&docLanguage=En](https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC(2018)47/FINAL&docLanguage=En)

The next two years were spent seeking an agreement on implementation rules for the PSI principles, and in particular for a consensus on the risk premia that would deliver discount rates for the purpose of grant equivalent calculations. To no avail.

2017 did see the introduction of two distinct reporting methods members could choose to apply. The institutional method essentially considered equity injections into PSI vehicles (chiefly bilateral development finance institutions (‘DFI’)) as ODA, subject to an eligibility self-assessment by the donor country concerned, with any reflows being counted as negative ODA. It was then in theory left to each individual DFI to report on the ODA component of its activities. The instrument method looked at the ODA value of each transaction made by a given donor country’s agencies and took no notice of its equity injections into its DFI. Grants made to the same institutions did however count towards ODA.

The impasse surrounding the risk premia debate resulted in December 2018 in the adoption of a set of provisional rules that essentially applied the pre-2014 cash flow method used for sovereign loans to PSI loans and equity investments and excluded guarantees (except when called, in which case the resulting pay-out is counted as ODA), and rather oddly mezzanine loans. The debate was scheduled to resume in 2021 in the light of the data published for the years 2018 and 2019.

The definition of the statistical system for the reporting of ODA is a multilateral and inherently political process that is negotiated between member states. Recognising the importance of complexities involved with arriving at appropriate ODA calculation methods, the CDFS is of the firm view that it is crucial for the representatives of all DAC members to be equipped with technical insights from a range of stakeholders to inform their positions.



2. Grant Element & Grant Equivalent

Because the decision was made to apply the grant equivalent/element method to most PSI, it is useful to discuss it and to point at the consequences of its inherent incentives.

2.1. Basic Principles

The grant element and grant equivalent are not new concepts, as the OECD explained in its 2017 ‘Working Paper No. 339: The grant element method of measuring the concessionality of loans and debt relief’.⁶

The grant equivalent of a loan represents the monetary value of the donor effort corresponding to the concessionality of a loan at the time it is extended. The concessionality is defined as the difference between the market rate of interest for a specific borrower, and the rate at which the concessional lender extends the loan.

One option is for the market rate to be defined as the interest rate at which the market is willing to lend to the borrower for a specific tenor. In this scenario, by agreeing to an interest rate inferior to the market rate, a concessional lender is essentially taking on risk for free, or ‘granting’ this difference in the price of money to the borrower.

It must however be remembered that the DAC statistical system is not tasked with measuring the benefit to borrowers, investees or grantees, but only donor effort. The cost to the donor, comprised of the lender’s own cost of funding operational costs and a risk premium specific to the borrower, could in this context also be used as the appropriate market rate.

Because the cash flows resulting from the repayment of the loan and the interest payments are taking place in the future, to understand how much this grant element is worth today and compare that to the face value of the loan, it is necessary to calculate the

present value of these future cash flows using a discount rate. The selection of this discount rate does have significant implications for the magnitude of the grant equivalent.

2.2. Examples

To illustrate the dynamics of grant equivalent and element calculations, the table in Annex 1 looks at two different loans.

- Both are for an amount of \$1 million, both are extended to a Low or Middle Income Country (LMIC), which in turn means the discount rate used is 7% (5 fixed discount rate + 2% income group adjustment).
- Loan 1 is associated with an interest rate of 4% and a tenor of 10 years.
- Loan 2 is associated with an interest rate of 5% and a tenor of 20 years.

Although Loan 1’s interest rate is lower, which would intuitively seem to be the more concessional, the longer tenor of loan 2 means that its Grant Equivalent is slightly higher, demonstrating the sensitivity of the Grant Equivalent to both the interest rate and the tenor, but also pointing at one of the limitations of a fixed discount rate. The market rate for lending to this sovereign would not be the same for 10 and 20 years - although the latter is not always higher than the former - and the decision to use a single discount rate for all tenors is an over-simplification.

The DAC’s decision to adopt a fixed discount rate rather than to use a market rate of interest for the purpose of grant equivalent calculations is an important topic in the current debate. It is perhaps useful to pause to illustrate this.

⁶[https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DEV/DOC/WKP\(2017\)5&docLanguage=En](https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DEV/DOC/WKP(2017)5&docLanguage=En)



Box 2: The power of discount rates

Albert Einstein is frequently if not always accurately quoted as marvelling about the power of compound interest rates. He presumably would have been equally vocal about the role of discount rates in the grant equivalent method.

Let us turn to a real-life example. In January 2021, Benin, a LDC, therefore associated with a discount rate of 9% according to the parameters of the DAC Statistical System grant equivalent method, issued an 11-year Eurobond for Euro 700 million with a 4.875% coupon. This was done in the market, and we will for the purpose of this argument assume this is the market rate.

Let us assume that a donor country extended a Euro 1 million loan with the same tenor in the same currency and with similar terms associated with an interest rate of 3%.

Using and market rate and then the fixed discount rate to calculate the grant equivalent and the grant element does yield, as could be predicted, very different results. For the exact same loan. Incidentally, the 10-year rates were at the time negative for some donor countries. Notwithstanding the selection of the risk premium that would be added to arrive at a cost-of-funding-based discount rate, it is clear that the grant equivalent for this loan would be even lower than for the market rate scenario.



2.3. Consequences for Incentives and Mobilisation

Much of the criticism levelled at this aspect of the system by civil society organisations ('CSOs') has focussed on the ODA inflation that relatively high fixed discount rates may have generated in a low interest environment⁷.

Having entered an inflationary environment associated with rising interest rates across hard currencies, the interest rates at which

loans to sovereigns are extended are likely to increase to reflect donor countries funding costs. It is not at all impossible that these will in time get close enough to the fixed discount rates to render the Grant Equivalent of such loans negligible. This would lead to ODA 'deflation' without any real reduction in donor effort.

In a scenario where the Grant Equivalent of loans to a country becomes very low or even negative, there would exist a disincentive to offer concessional lending at a time of increased need on the part of the borrowing

⁷ https://www.publishwhatyoufund.org/wp-content/uploads/dlm_uploads/2022/03/Giving-Credit-Where-Credits-Due-QA.pdf



country as it is facing an increasing cost of debt on the market. Re-setting discount rates at a time of stress may be construed as opportunistic and vindicate the system's detractors.

Particularly where loans to sovereigns are concerned, there is no veritable technical barrier to utilising country-specific market rates observable at the time of loan origination.

An artificially fixed discount rate system does present the risk of perverse incentives for lenders to focus on lending to countries for which the market rate is lower than the discount rate for their income group due to a comparatively higher credit quality rather than to other countries in the same group.

Looking back to the Benin scenario discussed above, lending to Benin at the market rate would mean a donor country would be generating more ODA but taking less risk, making less of an effort than it would by lending to another LDC for which the market rate is closer to 9%.

Even in the absence of any disingenuous behaviour, this simply means that relative donor effort will not be appropriately recognised.

The lack of reference to market rates also creates a risk to the broader private capital mobilisation agenda, by potentially creating incentives to compete away private lending available at a market rate that is not significantly higher than the 'concessional' rate offered. In such a scenario the donor country's effort is one private investors would be quite willing to make.

The decision by DAC members to add an adjustment factor to 'incentivise lending on highly concessional terms to LDCs and other LICs'⁸ could equally be applied to market rates. The definition of income group-based premia may in any event not provide for a true measure of credit risk. It may be useful to consider the use of the export credit risk premium system.

President Macron did, at COP 27, call for a 'huge shock of concessional financing'⁹. It is crucial that the statistical system should be appropriately calibrated to ensure the incentives it creates deliver the concessionalism and ultimately the progress towards sustainable development that world leaders are calling for.

⁸<https://www.oecd.org/dac/OECD%20DAC%20HLM%20Communique.pdf>

⁹ <https://www.politico.eu/article/emmanuel-macron-backs-climate-cash-trillions-cop27/>



3. Private Sector Instruments

This section will review and where appropriate discuss the calculation methods envisaged in 2016, the provisional methods adopted in 2018, and discuss their implications for incentives and private capital mobilisation.

3.1. Loans

Provisional Method

The provisional method agreed upon in 2018 states that loans to private sector entities will be counted on a cash flow basis. This means that ODA is inflated at the time the loan is extended and deflated as repayments take place. In a direct contradiction of the related 2016 principle, there is a 25% grant element threshold, with the grant equivalent being calculated using a fixed 10% discount rate. This is akin to the system in place for loans to sovereigns prior to 2014 and therefore does not, by the DAC's own admission, adequately incentivise the use of PSI loans¹⁰.

2016 DAC HLM Method

As discussed above, the 2016 DAC HLM decided that loans to private sector entities should be counted according to the grant equivalent method. The discount rates should be based on the income group differentiated rate for the relevant country and augmented by a risk premium to reflect the higher risk of lending to a private sector entity.

Because, at least at the time, the DAC members determined that PSI should not be concessional, ODA eligibility is conveyed by the loan's additionality and the 2016 communique stated that 'there should either be no threshold or a purely technical threshold' for ODA eligibility¹¹. It is important to note that this is an eligibility check and that the level of additionality is neither measured nor is it a factor in the calculation of the ODA value of the loan.

Notwithstanding the fact that the DAC members could not arrive at an agreement pertaining to the risk premia, and that the Grant Equivalent method is as a result not currently implemented for PSI loans, it is worth interrogating the consequences of its eventual enforcement.

Incentives & Mobilisation

The incentives implications of such a method risk - through linking the grant equivalent of a lending transaction to the spread between the interest rate offered and a fixed discount rate inclusive of a private sector risk premium – encouraging the very concessional lending DAC members are refusing to entertain in a private sector context.

This would add to the existing pressure on PSI vehicles to meet equally fixed deployment objectives and would in turn be likely to have consequences for private capital mobilisation dynamics, by creating an incentive to price out potential private lenders, and at times other DFIs with a higher cost of funding.

Discussion of Possible Adjustments

As mentioned earlier, the Grant Equivalent method was originally designed to measure donor effort linked to concessionality. In a scenario where, by the very determination of DAC members, there cannot be any concessionality, the donor effort needed redefining.

The rationale for PSI put forward by the DAC instead revolves around additionality, although the donor effort required to deliver additionality is still the relevant metric for ODA reporting. Beyond the prerequisite 'development

¹⁰ <https://www.oecd.org/dac/DAC-HLM-Communique-2016.pdf>

¹¹ <https://www.oecd.org/dac/DAC-HLM-Communique-2016.pdf>



additionality', additionality is defined by the DAC as either financial additionality or value additionality.

Financial additionality

The financial additionality of a PSI, as described in Box 1 above, refers to either:

- The inability for the funding to be sourced from the private sector with similar term (supposedly excluding pricing, given the mandated absence of concessionality) or quantity.
- The mobilisation of private capital that would not be available without the loan

In this case it could be argued that the donor effort is, assuming that there is supporting evidence for eligibility, the effort incurred to lend to this counterparty. The calculation method for loans to sovereign borrowers assumes that the donor effort is linked to the concessionality of the loan. This implies that lending at the market rate, or in the event at the fixed discount rate means the donor incurs no effort.

The DAC's insistence that the – generally but not systematically - higher risk of lending to the private sector should be recognised when counting ODA suggests that it considers this additional risk required to deliver additionality as a donor effort, and it therefore makes sense that an appropriate risk premium should be recognised in the calculation method. This is a complex issue, as there is a considerably wider array of 'market rates' across geographies, sectors, corporate entity sizes, etc... The use of a small number of arbitrary fixed risk premia is therefore both more justifiable, given the relative difficulty of applying actual market rates, and obviously more erroneous as this is a magnified version of the problem highlighted above for loans to sovereigns.

A real risk of contradiction however lies in the idea that the grant equivalent should, as it is for loans to sovereigns, be based on the difference between the lending rate and a fixed discount rate augmented by a fixed risk premium. Since

DAC members insist that there should be no concessionality, there should in theory be no lending below the market rate, as represented by the simplifying fixed discount rate to which the private sector risk premium is added.

Lest the system be in breach of the principles, it therefore does seem that the ODA calculation method should 'reward' the risk premium and not the difference between the lending rate and the fixed discount rate, which in theory should not exist. The fact that many PSI loans are being extended at floating interest rates does incidentally complicate matters.

In other words, the precedent set by the grant equivalent method for loans to sovereigns suggests that lending to sovereigns at the appropriate adjusted discount rate represents no donor effort. Lending to the private sector at the 'market rate' however, given the assumed higher risk involved, would under the proposed method be recognised as representing a donor effort. Whilst loans to private sector entities are not meant to be concessional, the lending rate must be assumed to be the market rate for the specific borrower or category of borrowers. The donor effort would therefore be the private sector risk premium over and above the relevant sovereign discount rate for the specific borrower or category of borrowers.

The grant equivalent should in turn reflect this. This could be done quite simply by discounting repayments by the lending rate augmented by the relevant private sector risk premium, rather than by a fixed discount rate plus the risk premium. The lender would thus only be rewarded for the higher risk of lending to the private sector, not for concessionality.

Value additionality

The value additionality of a PSI is defined as non-financial value the borrower would not receive from a private sector counterparty.

The question here is whether the pricing of the loans covers the cost of this non-financial value. Should this be the case, then the calculation suggested above would suffice.



Should this not be the case, the associated donor effort could presumably be expressed as the cost of these services, which must be recorded in the relevant donor entity's accounts. This could then be added to the donor effort associated with lending to a private sector entity as suggested above.

3.2. Guarantees

Provisional Method

The provisional method agreed upon in 2018 states that guarantees do not qualify for ODA reporting, unless they are 'called', in which case the pay-out is reported according to the cash-flow method. This is of course creating a disincentive for their use as, in contrast to PSI loans, there is no short-term ODA reward.

2016 DAC HLM Method

The 2016 communiqué states that guarantees too will be counted according to the Grant Equivalent method but, since 'guarantees are non-funded instruments, the discount rates will only take into account operating costs and risk adjustment factors (not the funding cost)'¹².

There is no mention of the ODA implications of a called guarantee, so the assumption has to be that the donor effort this would generate would be covered by the 'risk adjustment factors'.

Incentives & Mobilisation

The difference in the treatment of loans and guarantees has significant implications for incentives and mobilisation alike.

DFIs that are regulated and subject to, for example, the Basel framework, will be acutely aware of the fact that the risk weights approach to credit exposure makes for a broadly even treatment of loans and direct credit substitute guarantees. Even for those non-regulated guarantee-issuing entities that can use both

instruments, deployment objectives and/or operational simplicity are likely to make loans more attractive. An unfavourable comparative ODA treatment is therefore likely to create an even stronger disincentive to use guarantees as opposed to loans. The OECD itself notes in its 2021 paper on the use of guarantees that:

*"ODA-eligibility is an important factor for many donors in their choice of development finance instrument. Further discussions on how to provide better incentive structure for donors regarding the use of guarantees in their bilateral programmes will be needed to widen the use of the instrument."*¹³

This is a very real concern for private capital mobilisation dynamics. Guarantees are not only capable of delivering the two types of financial additionality defined by the DAC, but they present the significant advantage of temporarily assisting new investors to enter a market, rather than hoping they are ready to invest *pari-passu* with the official sector. Guarantors at times only need to shoulder a specific tranche of the risk to make a debt issue attractive to private investors. Assuming they are appropriately compensated for the risk covered, this is not concessional, but does address the self-evident fact that PSI vehicles and traditional institutional investors seldom have similar levels of risk appetite.

Private sector investors mobilised through the use of guarantees may not get the full experience by virtue of being sheltered from part or all of the credit risk, but a precedent is set. Investors do gain direct access to performance data, and first-hand experience of the market they are being ushered into.

It is also worth noting that there has been an observably higher willingness to provide guarantees to local currency instruments than there is to lend in local currency, which does address a long identified systemic issue in development finance.

¹² <https://www.oecd.org/dac/DAC-HLM-Communique-2016.pdf>

¹³ Garbacz, W., D. Vilalta et L. Moller (2021), « The role of guarantees in blended finance », *OECD Development Co-operation Working Papers*, n° 97, Éditions OCDE, Paris



The guarantees debate provides early evidence of the argument that will be made in section 4. The Basel framework recognises the credit risk exposure associated with a loan and a direct credit substitute guarantee to the same counterparty and treats these in a similar fashion.

The proposed Grant Equivalent method does make sense from this standpoint, recognising that, once the cost of funding and potentially the balance sheet cost are accounted for, the treatment of guarantees should not be inferior to that of loans.

3.3. Equity

Provisional Method

Equity investments are to be counted based on cash flows until further notice. There is a cap on reflows set at the value of the original investment. Essentially any losses are counted as ODA, but there is no negative ODA impact where profits are made.

2016 DAC HLM Method

Here again the proposed calculation method is the Grant Equivalent, albeit adapted in recognition of the unpredictability of reflows in an equity investment context. In a first instance however the full-face value of the investment will be counted as ODA. The reflows will be discounted ex-post, once again using the DAC's set of income-group-based discount rates to calculate their present value when the investment is exited. There is a reference to the use of the traditional ex-ante method when there is enough information to map cash flows at the time of making the investment.

One can at first only assume that these discount rates will reflect the different nature of equity risk, although little information is available around this point. The negative ODA generated by reflows is however capped at the original value of the investment, on a non-inflation-adjusted basis. This means that the

uncapped profits of an equity investment will not count as negative ODA. This is a seemingly unique case of potentially significant cash flows benefiting donor countries being completely ignored for ODA counting purposes. Whilst this may be justified in terms of incentives, the risk asymmetry is worth interrogating.

Incentives & Mobilisation

Until such time as the discount rates are agreed upon, and we know whether equity reflows are discounted using a different rate than other instruments, it is difficult to discuss the incentives dynamics the proposed method will create. The risks associated with equity investments may be deemed to represent a significant donor effort. The question is to establish the strength of the incentive created by 'non-ODA-taxable' reflows in the form of profits on equity investments, and its coherence within the wider statistical system.

This incentive is mitigated for regulated PSI vehicles given the very high risk-weight of private equity investments (400% of exposure under the market-based approach of Basel III¹⁴).

Once all other PSI are counted using the Grant Equivalent method, the ex-post approach to equity investments will also mean that they, alongside grants, will be the best way to generate large amounts of immediate ODA, leaving the capped reflows and uncapped profits to be dealt with at a much later date.

3.4. Sense & Consequences

DAC members did in their 2016 communique clearly identify that the statistical system designed to count ODA should be and would be 'offering the right incentives and removing disincentives in the use of these (private sector) instruments'¹⁵.

The imagery of the nesting dolls is an imperfect but perhaps useful way to envisage the system within which this debate is inscribed. The

¹⁴ https://www.bis.org/bcbs/publ/d424_hlsummary.pdf

¹⁵ <https://www.oecd.org/dac/DAC-HLM-Communique-2016.pdf>



largest such doll is the ODA target, which in places acts as a ceiling. Within this, smaller dolls representing grants and financial instruments compete for space. Within the financial instruments doll, there is tension between dolls respectively concerned with loans to the public sector and PSI programmes. And within the PSI doll, individual instruments ranging from grants and equity to guarantees and loans must equally find their place, or rather, their size.

Many factors affect these doll-conflicts. Individual institutions will need to allocate finite resources across instruments based on their own institutional objectives and Key Performance Indicators. Most will need to operate within politically decided agendas. Some will, by dint of their structure and status, need to abide by regulatory and prudential frameworks that set limits for, or assign a differentiated regulatory capital cost to different instruments.

All will be subject to and influenced by ODA reporting rules.

The primary concern of this CDFS Short Read is the dynamics at play within the comparatively small PSI doll. The DAC statistical system can create two different types of incentives or conversely disincentives.

The first category is, it is assumed, involuntary and linked to the distortions created by an imperfect system. This category for example includes the incentives and disincentives created by the use of an arbitrary set of discount rates, and more generally by a perhaps necessarily oversimplified approach.

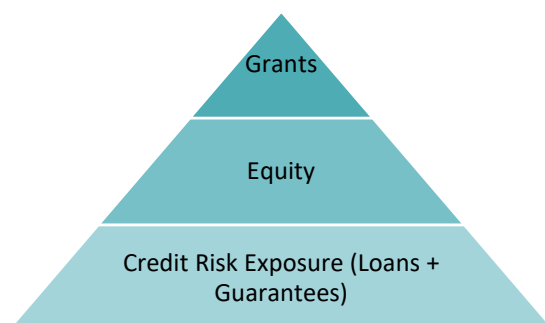
The second category is comprised of the incentives and disincentives created by the relative treatment of the different PSIs. This is a complex issue, because whilst the statistical system is in theory purely based on the measurement of donor effort rather than on the impact created for beneficiaries, decisions made in its design process will have implications for the successful attainment of the

objectives of the development system it is supposed to serve.

If for example PSI A is far more efficient at mobilising private capital than PSI B, meaning that it requires a lower amount of donor effort to generate the same level of mobilisation, then there is a risk that the statistical system might disincentivise its use vis-à-vis PSI B. Because the statistical system started life as a cash system, there is for example a built-in bias in favour of funded instruments, conversely against unfunded instruments such as guarantees, that should be addressed. In stark contrast to the domain of grants, the primary contribution of financial instruments, whether in the public or private sector context, is not cash, but risk. Cash is of course needed, but it matters not primarily whose cash it is. What matters most is who bears the risk.

This suggests that, as will be discussed in Section 4, it might be possible for DAC members to leverage off the considerable body of work their own financial regulators have built over the years to count risk. In the short term however, the priority should be to ensure that the DAC statistical system focusses on the relative incentivisation of PSIs. If a bias is created in favour of one PSI over another, it should at least be done knowingly.

If taking on risk is acknowledged as the key effort made by donors where financial instruments are concerned, then the hierarchical pyramid of PSI incentives should in theory have grants, as providing a 100% probability of loss, at its pinnacle, followed by equity, with loans and guarantees forming an approximately even base.





According to the DAC 2014 High Level Meeting statement, 'ODA credit counted and reported will be higher for a grant than for a loan'.¹⁶ A decision to adopt a risk-based statistical system needs not, indeed should not if accurately calibrated, result in disincentives for the use of grants. A calibration phase would allow DAC member countries to analyse data, and any strong shift away from one specific instrument could be construed as grounds for interrogation of the system's parameters.

It should also be remembered that the regulatory circumstances of PSI vehicles and actors are not uniform, and that some will have to comply with regulatory obligations that will apply a distorting lens to the relative incentives created by the statistical system. The same is

true of their structure. A guarantee programme, operated by a development agency and backed by its country's treasury is subject to dynamics quite remote from those affecting a regulated bilateral DFI's own balance sheet based guarantee activity.

The creation of a statistical system designed to measure the effort involved in the use of financial instruments in isolation from the wider regulatory and prudential frameworks, frameworks to which some of the institutions charged with its implementation are actually subjected to, appears to be an unnecessarily challenging task. As is often the case in capital markets, there might be an opportunity to leverage off the existing infrastructure.

¹⁶<https://www.oecd.org/dac/OECD%20DAC%20HLM%20Communique.pdf>



4. Inverted Basel, or a Touch of IFRS?

The DAC has correctly stated that the cash flow method was not adapted to the recognition of the donor effort where financial instruments are the mode of ODA delivery. This essentially assumed that all borrowers were guilty of default until proven innocent, and that all equity projects were doomed to complete failure until reflows proved otherwise. Whilst it provided an artificial ODA boost in the short term, it further failed to recognise the very real donor effort associated with risk exposure. Nowhere is this more evident than in the case of guarantees, which, absent a cash element, are not deemed worthy of ODA recognition until they prove their worth by being called, resulting in a cash payout to the protected entity.

The DAC's inability to agree on mutually acceptable discount rates does mean that the cash flow method endures for PSIs. This is temporarily an opportunity lost for development finance, but by delaying the adoption of the set of discount rates at the core of the grant equivalent method, it might have created an opportunity.

An opportunity for DAC members to leverage off the considerable amount of time, money and expertise expended to create reporting, regulatory and prudential frameworks, ranging from IFRS and Basel to Solvency, that share a common basis: the necessity to count risk.

In an increasingly global and financialised economy, all actors are impacted by these sets of rules. Development finance lies at the intersection of policy and finance. As it seeks to mobilise private capital, it is increasingly pulled towards capital markets. It should be self-evident that it must increasingly take into account the rules that regiment their functioning.

Many of the bilateral PSI vehicles tasked with the deployment of development finance are –

rightly – regulated as financial institutions in their respective jurisdictions. Multilateral development finance institutions are to an extent 'regulated' by the Credit Rating Agencies ('CRAs') that hold the key to affordable funding on capital markets. CRAs are themselves intricately linked to regulatory and prudential frameworks.

IFRS

The International Financial Reporting Standards ('IFRS') and in particular IFRS 9, dedicated to financial instruments are perhaps the best example of a framework that is relevant to most actors in development finance. The likes of BII, Proparco and FMO do for example report in compliance to IFRS.

It is not within the scope of this short read to go into the minutia of IFRS 9, but it is sufficient to note that a core concept is the calculation and reporting of an 'expected credit loss' ('ECL') framework. One important measure is lifetime ECLs, which 'are an expected present value measure of losses that arise if a borrower defaults on its obligation throughout the life of the loan'¹⁷.

Should DAC members decide to calculate the donor effort created by the use of financial instruments on the basis of the risk they incur, ECL calculations, in extenso the present value of the actual cash they expect to lose, could constitute a useful starting point. It must of course be remembered that their PSI vehicles typically already make these calculations on an annual basis.

Basel

Since many PSI vehicles, and many of the investors they are tasked with mobilising are subjected to rules designed to disincentivise financial risk, it stands to reason that a system

¹⁷ <https://www.bis.org/fsi/fsisummaries/ifrs9.pdf>



tasked with measuring effort should at least recognise that for these actors, risk taking demands an effort, and seek to mitigate this downward pressure on risk appetite.

This is even more true of a system that increasingly seeks to offer incentives and remove disincentives.

Basel III has, in the wake of the financial crisis, ushered in a new set of risk weights for financial exposure to a series of instruments. Tables 2 to 5 provide some directly PSI-relevant highlights from the Bank for International Settlements' high-level summary¹⁸. Risk weights referred to in the discussion are against a green background.

Exposure to banks						
Risk Weights in jurisdictions where the ratings approach is permitted						
External Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	20%	30%	50%	100%	150%	SCRA
<i>Short-term exposures</i>						
Risk Weight	20%	20%	20%	50%	150%	SCRA
Risk Weights where ratings approach is not permitted and for unrated exposures						
Standardised Credit Risk Assessment Approach (SCRA) grades				Grade A	Grade B	Grade C
Risk weight				40%	75%	150%
Short-term exposures				20%	50%	150%
Exposure to general corporates						
Risk Weights in jurisdictions where the ratings approach is permitted						
External Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	20%	50%	75%	100%	150%	100% or 85% for corporate SMEs
Risk Weights where ratings approach is not permitted						
SCRA grades			Investment Grade		All other	
General corporate			65%		100%	
SME general corporate			85%			

Table 2: Basel III Revised standardised approach to credit risk weights: Credit

Exposure to project finance, object finance and commodities finance		
Exposure	Project finance	Object and commodity finance
Issue-specific available and permitted	Same as for general corporate	
Rating not available or not permitted	130% pre-operational phase 100% operational phase 80% operational phase (high-quality)	100%

Table 3: Basel III Revised standardised approach to credit risk weights: Project finance

Subordinated debt and equity (excluding amounts deducted)				
	<i>Subordinated debt and capital other than equities</i>	<i>Equity exposures to certain legislated programmes</i>	Speculative unlisted equity	<i>All other equity exposures</i>
Risk weight	150%	100%	400%	250%

Table 4: Basel III Revised standardised approach to credit risk weights: Subordinated debt and equity

Credit Conversion Factors for off-balance sheet exposures					
	<i>UCCs</i>	<i>Commitments, except UCCs</i>	<i>NIFs and RUFs, and certain transaction-related contingent items</i>	<i>ST self-liquidating trade letters of credit arising from the movement of goods</i>	Direct credit substitutes and other balance sheet exposures
CCF	10%	40%	50%	20%	100%

Table 5: Basel III Revised standardised approach to credit risk weights: CCF for OBS exposures

¹⁸ https://www.bis.org/bcbs/publ/d424_hlsummary.pdf



It is important to note that the ratings approach will not always be relevant to the PSI activities of development finance actors, who will as a result need to use the standardised credit risk assessment ('SCRA'). It however is the relation between risk-weights assigned to different types of exposure that is most directly relevant, although it should be noted that the relatively low coverage of emerging markets by CRAs is not helpful to mobilisation dynamics, and that remediation efforts could represent a useful expenditure of donor effort.

Basel III does provide clearly differentiated risk weights for categories of exposures that are directly relevant to development finance, ranging from credit exposure to banks to project finance, and from SME lending to equity investments.

Speculative unlisted equity, which according to the European Banking Authority's August 2019 paper should arguably 'be broadly equivalent to investments in private equity or venture capital firms'¹⁹, is assigned a 400% risk weight, while credit exposure to single B banks has a risk weight of 100%.

The consequences of Basel III for equity investment by development banks were clearly identified in AFD's excellent 2020 paper 'Financial regulation of national development banks'.²⁰

It should also be noted that 'direct credit substitutes, eg general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances) will receive a CCF of 100%'.²¹

It follows that a system seeking to measure the effort consented to in a financial instruments context should consider the relative levels of effort imposed by relevant frameworks on PSI

vehicles. At the risk of oversimplifying the situation, for a bilateral DFI subject to Basel III, investing in a private equity fund represents a 'risk' effort four times higher than lending to a B-rated bank. Providing a full direct credit substitute off-balance sheet guarantee on a loan to a bank attracts a 100% CCF and therefore results in an exposure amount commensurate with that linked to extending the same loan.

Adopting an ODA PSI calculation method that is essentially an inverted image the risk-weights enforced by prevailing regulatory and prudential frameworks would not only leverage off years of work on the part of capital markets stakeholders and of the DAC member states themselves to more accurately measure donor effort, but also go some way towards compensating for the disincentives for risk taking built into the financial system, and shaping the development finance system of institutions according to the realities of those private institutional investors it is tasked with mobilising.

Should a neutral approach not be deemed desirable this could in turn be adapted to create 'the right incentives' the 2016 DAC HLM Communique seeks to offer. Guarantees may be deemed to have a higher mobilisation potential than loans. Equity investments could be recognised as delivering a higher level of additionality by dint of the relative scarcity of private sector sources of equity capital in emerging markets. The realities of debt relief could be built into the upfront recognition of donor effort. The 2014 High Level Meeting recognition of grants as commanding the highest donor effort could be protected.

This would of course further transform the DAC statistical system from a measurement tool to an incentives system, but it seems clear that this has been a foregone conclusion for some time.

¹⁹ <https://www.eba.europa.eu/eba-advises-the-european-commission-on-the-implementation-of-the-final-basel-iii-framework>

²⁰ <https://www.afd.fr/en/ressources/financial-regulation-national-development-banks-ndbs>

²¹ https://www.bis.org/basel_framework/chapter/CRE/20.htm?tidate=20191231&inforce=20191215&published=20191215



5. Conclusion

The measurement of ODA through the DAC statistical system has been widely adopted as the numerical representation of individual donor countries' generosity. As such it has become relevant both to the international stage and to the domestic political scene. Whether used as a target, a floor, a ceiling, or a combination thereof, how this consequential number is arrived at has grown in importance. The methods used for its calculations are therefore rightly the subject of negotiations among DAC member states, and of concern across the development sector.

Whilst it should be deemed desirable to build a system that does not create undue disincentives for the use of specific instruments, it should also be clear that re-calibration does not need to be done through alignment with existing methods yielding high grant equivalents. To avoid ODA inflation, it is necessary to consider the system in its entirety and to ensure that this important exercise does not result in a lower level of donor effort for a constant level of reported ODA.

As ODA reporting increasingly involves financial instruments, the dynamics it creates will inevitably interact with a system of existing frameworks. The incentives their respective set of rules create will reinforce or undermine one another. If DAC members wish the statistical system to transform from a measurement tool into an incentives-based instrument of policy delivery, they need to be equipped with an understanding of this wider system. They are also presented with an opportunity to build on

the shoulders of the giant efforts deployed to create the existing infrastructure of financial markets.

Building a statistical system that seeks to find equivalence between grants and financial instruments and identifies one measure for both cash donations and risk-exposure, is a daunting task. As is most often the case in matters financial, the solution probably does not lie in the reinvention of a wheel, but in the identification and refitting of an existing, fit-for-purpose wheel.

The question therefore should be whether it is optimal for resource constrained DAC members representatives to seek to create such a system ex-nihilo. For those who have crossed over from capital markets to development finance, it would make little sense. It is doubtful whether the notion would be met with any more understanding by those who have not.

Some measure of recognition of the rules PSI vehicles must abide by is not just a necessity. By acknowledging the world in which investors live, it is aligned with the growing urgency of the private capital mobilisation agenda.

As the challenges we collectively face grow in magnitude and in urgency, the further integration of the development finance system with capital markets is increasingly key. Speaking a common language, the language of risk, and building coherent frameworks seems like a good place to start.



Annex 1: Grant Equivalent / Element calculations

Year	Loan Disbursement	Cash Flows Loan 1 (4% Interest Rate)	Cash Flows Loan 2 (5% Interest Rate)	Discount Factor (7%)	Discounted Cash Flows Loan 1	Discounted Cash Flows Loan 2
0	\$ 1,000,000.00			1.0000		
1		\$ 40,000.00	\$ 50,000.00	1.0700	\$ 37,383.18	\$ 46,728.97
2		\$ 40,000.00	\$ 50,000.00	1.1449	\$ 34,937.55	\$ 43,671.94
3		\$ 40,000.00	\$ 50,000.00	1.2250	\$ 32,651.92	\$ 40,814.89
4		\$ 40,000.00	\$ 50,000.00	1.3108	\$ 30,515.81	\$ 38,144.76
5		\$ 40,000.00	\$ 50,000.00	1.4026	\$ 28,519.45	\$ 35,649.31
6		\$ 40,000.00	\$ 50,000.00	1.5007	\$ 26,653.69	\$ 33,317.11
7		\$ 40,000.00	\$ 50,000.00	1.6058	\$ 24,909.99	\$ 31,137.49
8		\$ 40,000.00	\$ 50,000.00	1.7182	\$ 23,280.36	\$ 29,100.46
9		\$ 40,000.00	\$ 50,000.00	1.8385	\$ 21,757.35	\$ 27,196.69
10		\$ 1,040,000.00	\$ 50,000.00	1.9672	\$ 528,683.26	\$ 25,417.46
11			\$ 50,000.00	2.1049		\$ 23,754.64
12			\$ 50,000.00	2.2522		\$ 22,200.60
13			\$ 50,000.00	2.4098		\$ 20,748.22
14			\$ 50,000.00	2.5785		\$ 19,390.86
15			\$ 50,000.00	2.7590		\$ 18,122.30
16			\$ 50,000.00	2.9522		\$ 16,936.73
17			\$ 50,000.00	3.1588		\$ 15,828.72
18			\$ 50,000.00	3.3799		\$ 14,793.20
19			\$ 50,000.00	3.6165		\$ 13,825.42
20			\$ 1,050,000.00	3.8697		\$ 271,339.95
				Present Value	\$ 789,292.55	\$ 788,119.72
Loan 1	Grant Equivalent	\$ 210,707.45				
	Grant Element	21%				
Loan 2	Grant Equivalent	\$ 211,880.28				
	Grant Element	21%				



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