A matter of high interest
Assessing how loans are reported as development aid
By Stéphanie Colin

Introduction
An increasing number of European governments and multilateral development banks (MDBs) have been replacing traditional Official Development Assistance (or ‘aid’) grants to developing countries with loans that have preferential – or ‘concessional’ - terms. As long as specific conditions are met, these loans can count towards the commitment made by donors to spend 0.7% of their gross national income as aid by 2015.

The member governments and institutions of the OECD Development Assistance Committee (OECD-DAC), the body responsible for collecting aid statistics, are currently reviewing the relevance of these conditions in today’s market environment with a view to make a proposal for revision in June 2014.

This reform takes place in a context of decreasing overall aid budgets globally where loans can be seen as an attractive way to increase aid without budgetary costs.

This briefing, which is a summary of a comprehensive, fully referenced report – also available online – analyses the current debate and assesses how the rules on concessional lending should be updated to ensure that development objectives remain at the core of aid reporting.

The report finds that the current system:

- Lacks a clear development logic by allowing profit-making loans to count as aid.
- Is open to abuse by donors because of its ambiguity.
- Inflates the value of donors’ commitments.
- Risks increasing debt distress in poor developing countries.

Specifically, the report finds a number of critical problems with the existing system.

The use of an arbitrary and very high reference rate allows donors to borrow money on financial markets and re-lend it to developing countries at a higher rate. They can therefore make money on concessional loans, and increase ODA levels without increasing their actual aid budgets.

The use of a vague ‘concessional in character’ requirement can allow risk-mitigating mechanisms - sovereign guarantees and credit risk - to count as aid, while the lack of a clear interest rate benchmark means that donors are free to interpret when a loan is concessional.

Aid figures are inflated in several ways:

- All loans with a grant element of at least 25% - whether it is 26% or 99% - are treated equally in aid statistics which record the full value of the loan and not the concessional elements only.
- The 10% reference interest rate used in the first test dates back to the early 1970s and is too high compared to current interest rates at which donors can raise funds. This overvalues the loan’s grant element and the loan’s corresponding value in aid statistics.
- Interest repayments on loans are not deducted from gross aid figures which overvalues actual net transfers to recipient countries.

Loans are incorrectly portrayed as a viable financing option for poor countries, while in practice:

- Loans are concentrated in middle-income countries and productive sectors where economic returns are high.
- Concessional borrowing has been the main driver of recent debt accumulation in poor heavily indebted countries.
- Donors are disincentivised from increasing the concessional element of their loans, as noted above.
Problems with loan reporting

A loan provided by a government or multilateral institution to a country on the OECD DAC’s list of official aid recipients can be counted as development aid if: (a) its main purpose is development; (b) the loan has a grant element of at least 25%; and (c) is ‘concessional in character’.

The grant element test

Our report finds the grant element test used to assess a loan’s eligibility as aid to be deficient. The test compares the ‘concessional loan’ to a loan with the same total repayments offered at an interest rate of 10%. If the difference between the value of the two loans is more than 25% of the value of the ‘concessional’ loan, then it passes the grant element test. The 10% figure on which this test is based is arbitrary and not based on any reference to the real market cost to the lender. The 10% benchmark was set at a time when interest rates in donor countries were much higher and is therefore no longer adequate as donors can borrow at far lower rates. For instance, G7 countries could borrow on average at 2%, issue a loan to a partner country at 4.75% and still meet the grant element test, despite the fact that they are making a profit on the loan.

The concessional in character test

Given the ease with which the grant element test can be met in the current context of low interest rates, the ‘concessional in character’ test largely determines when a loan can count as development aid.

However, the definition of this requirement as ‘below market interest rates’ suffers from several ambiguities. Since 2012, the DAC Secretariat has facilitated a debate to try to agree “a clear, quantitative definition of concessional in character, in line with prevailing market conditions”. However, our report points out that this has so far not been concluded, leaving huge ambiguity. In effect the requirement is open to donors’ interpretations, which is problematic.

Firstly, the requirement can be interpreted from two different perspectives: from the recipient’s perspective (loans with lower interest rates than they could get from alternative financing on capital markets); or from the donors’ perspective (loans at more favourable terms than donors can borrow themselves from capital markets). Our report shows how the former interpretation has been used by France and Germany to justify counting profit-making loans as aid.

Secondly, there is no agreed reference level for ‘below market rates’. All proposals made by the DAC Chairs in this direction failed to reach a consensus. According to these proposals, concessional rates should be at least 25% lower than the OECD’s Differentiated Discount Rate (DDR), which is already used to measure the concessionality of tied aid and export credits. The DDR is calculated for OECD countries based partly on the current cost to them of borrowing by issuing bonds, but is adjusted after negotiation. This negotiation means that most loan-giving donors are currently using the DDR, which is higher than their bond rates, as the chart above shows, allowing them to make a profit out of lending.

Finally, no budgetary effort is explicitly required to justify a loan’s concessional character. This has led to contentious reporting by the EU, France and Germany in 2009 and 2010, who argued that market-raised loans including no official subsidy but supported by risk-mitigating mechanisms in the form of public guarantees and free credit risks, should be accepted as concessional.

In April 2013, the DAC Secretariat agreed to count these unsubsidised loans in 2011 and 2012 aid figures. Allowing different practises not only undermines the credibility of the requirement, it is also unfair to other donors attempting to fulfil their aid commitments with real fiscal contributions.

Moreover, counting public guarantees and the absence of remuneration for credit risks in concessionality assessments allows for double-reporting as these are already recorded as aid in the case of a loan default.

A dangerous domino-effect could inflate aid figures significantly if more donors started to report a large share of their market-based loans. This would inflate bilateral aid by up to $20 billion per year, and multilateral aid by up to $50 billion per year.

Several proposals have attempted to address these loopholes in the past but have failed to reach a consensus among DAC members. Our report stresses that it is of paramount importance that DAC members seize the current reform opportunity to move away from an anachronistic situation where loans are assessed against 40-year-old conditions.

Inflated aid figures

Aside from the scenario examined above, the report further highlights how the current rules are already inflating aid figures in three different ways.

Firstly, the full loan amount is recorded as aid, not only the concessional grant element. Eurodad’s report highlights why reversing...
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this would incentivise donors to provide highly concessional loans and how this is technically feasible by building on the existing DAC methodology for associated financing.

Secondly, the high reference interest rate overvalues concessionality levels making more loans count as aid. Under a lower benchmark such as that used by the IMF, according to Development Initiatives, major DAC loan-giving countries such as France, Germany and Japan would have seen substantial reductions in the grant element of their concessional loans ($504 million, $603 million and $3.1 billion respectively, according to a paper by Development Initiatives).

Finally, interest repayments inflate aid as, unlike repayments of the principal loan itself, they are not deducted in net aid figures. For instance, in 2012, developing countries repaid €590 million as interest on loans, 90% of which came from EU institutions, Germany and France, and was not deducted from net aid figures (Aidwatch report). Interest repayments should be deducted from aid figures to provide a genuine picture of resource flows to and from developing countries.

Suitability of loans to poor countries in question

The report also raises concerns about the suitability of loans as development tools in the world’s poorest countries.

Public services and sectors key to eradicating poverty such as education and health have traditionally been financed through grants, while loans are predominantly used in productive sectors with high economic returns. Moreover, 85% of concessional loans from DAC countries focused on middle-income countries in 2011 (Development Initiatives paper).

Furthermore, even the IMF has acknowledged that concessional borrowing has been the main driver of recent debt accumulation in heavily indebted poor countries, threatening the successes of debt relief initiatives.

As such, the DAC recommendation to donors to deliver their aid to least developed countries through grants should be turned into a requirement to better acknowledge the special value of grant assistance.

Conclusion

The report finds that the tests assessing a loan's eligibility as development aid pose serious problems. Profit-making loans can count as aid thanks to outdated benchmarks; no budgetary effort is explicitly required from donors to justify a loan's concessional character; aid amounts are inflated by the current methodology; and debt impacts are not considered.

It is crucial to clarify both the quantitative test (grant element) and qualitative test (concessional in character) to ensure they are less ambiguous and therefore better fit for purpose.

Taking advantage of ambiguous rules, some donors such as the EU, France and Germany, have interpreted the rules to benefit themselves, and reported unsubsidised loans on which a profit has been made and loans supported by risk-mitigating mechanisms as development aid.

Such reporting not only goes against the altruistic spirit that the term ‘donor’ implies but is also fundamentally unfair to other donors trying to reach their aid quantity commitments with real fiscal contributions.

The report further highlights concerns that: aid will be inflated under current rules; a loan amount will be reported in full irrespective of the size of its concessional element; and the risk that repayments on loans destabilise economies of poor countries that recently achieved sustainable debt levels.

Recommendations

This report calls for the ongoing OECD DAC review to address current loopholes. Eurodad calls on governments from DAC member countries and institutions to:

Actively include civil society and partner country governments in the current discussions in order to produce a genuinely developmental reform outcome.

Deduct interest repayments from aid figures so that net aid provides a genuine representation of flows to and from developing countries.

Count only the grant element as aid to create the right incentives for donors to provide loans with the highest degree of concessionality.

Take steps to incentivise grant aid. The existing DAC recommendations that bilateral donors should reach a high average proportion of grants in their aid and use mainly grants in least developed countries should be turned into requirements.

Replace the 10% reference rate with a more relevant benchmark so that loans provided at high interest rates where a profit is made are not able to pass the 25% grant element test and count as aid.

Specify in the revised rules that loans should include a budgetary effort in the form of an official subsidy to qualify as concessional in character.

To read the full report go to: www.eurodad.org/amatterofhighinterest
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The European Network on Debt and Development is a specialist network analysing and advocating on official development finance policies. It has 48 member groups in 19 countries. Its roles are to:

- research complex development finance policy issues
- synthesise and exchange NGO and official information and intelligence
- facilitate meetings and processes which improve concerted advocacy action by NGOs across Europe and in the South.

Eurodad pushes for policies that support pro-poor and democratically-defined sustainable development strategies. We support the empowerment of Southern people to chart their own path towards development and ending poverty. We seek appropriate development financing, a lasting and sustainable solution to the debt crisis and a stable international financial system conducive to development.

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