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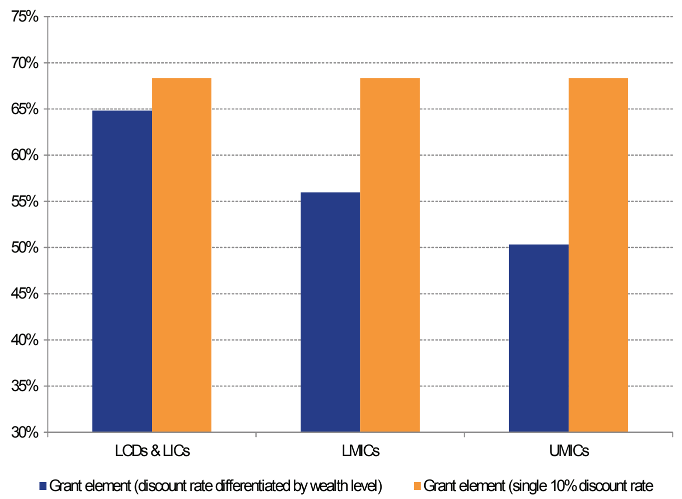
The new rules for Official Development Assistance loans: what's at stake?

- In December 2014, the High-Level Meeting of the OECD's Development Assistance Committee (DAC) approved a major reform of Official Development Assistance (ODA) loan reporting rules–the first change in over 40 years. This was a significant contribution by the OECD ahead of the international meetings held in 2015: the Addis Ababa conference on financing for development in July, and the adoption of new sustainable development goals (SDGs) in September in the context of the United Nations 2030 Agenda for Sustainable Developpement.
- The assistance reporting method will now be more consistent. Loan financial flows will no longer serve to determine donors' ODA figures. Donor effort will be measured only by the "grant equivalents" of loans, on top of outright grants. Previously, all loans with a grant element exceeding 25% could be fully reported as ODA, irrespective of their financing terms. The earlier system therefore had two major flaws: (1) a threshold effect (reporting when the grant element exceeded 25%), and (2) ODA variations determined by donors' loan cycles.
- To measure the "grant equivalent" of loans in the new system, the chosen reference–i.e., the "discount rate"–will no longer be uniform but will depend on the recipient country's income level. The wider the spread between the loan interest rate and the discount rate, the greater the loan's "concessionality". The former reference–the 10% discount rate–is abolished.
- The discount rate will now be higher when the recipient country has a low income level. It will range from 6% for an emerging country such as China or South Africa to 7% for a country such as Guatemala or Nigeria, and 9% for the poorest countries. For the same loan, the proportion recorded as assistance will thus be larger for a country with little or no access to market financing (see chart below). This approach recognises the donor's risk exposure and hence its financial effort.
- For the first time, the DAC has explicity linked its loan policy to compliance with IMF and World Bank rules for sustainable debt. Loans that do not comply with these rules will not be classified as ODA. Moreover, the assistance eligibility conditions have been tightened considerably for the poorest countries, with an increase in the minimum grant element from 25% to over 45%.

Illustration of difference in incentive effects of old and new assistance measurement systems



Source: DG Trésor calculations.

Explanation: The chart opposite shows that the grant element of a loan with identical characteristics (30-year maturity, 5-year grace period, 1% interest rate) will be assessed differently under the old and new systems. Furthermore, such a loan will be reported at a higher value if allocated to a least developed country (LDC) or low-income country (LIC) rather than to an emerging country (lower-middle income country [LMIC] or upper-middle income country [UMIC]).

MINISTÈRE DES FINANCES ET DES COMPTES PUBLICS

MINISTÈRE DE L'ÉCONOMIE DE L'INDUSTRIE ET DU NUMÉRIQUE

1. The OECD Development Assistance Committee (DAC) defines the notion of Official Development Assistance (ODA)

The Development Assistance Committee (DAC) was formed in the early 1960s in the wake of the Marshall Plan and the establishment of the Organisation for Economic Co-operation and Development (OECD). Its mandate is to contribute to "making national resources available for assisting countries and areas in the process of economic development and for expanding and improving the flow of long-term funds and other development assistance to them". Its action has focused on negotiating international cooperation policy recommendations for its members. In 1972, the DAC produced a qualitative and quantitative definition of the notion of Official Development Assistance (ODA), for the purpose of measuring donors' financial contributions to developing countries and ensuring greater transparency of these flows. The notion of ODA is governed by directives negotiated between DAC members, spelling out assistance eligibility criteria for their official interventions in developing countries.

1.1 Official Development Assistance and concessionality of assistance: two concepts regularly discussed in the DAC and elsewhere

The 1972 agreement defines ODA as "those flows to countries and territories on the DAC List of ODA Recipients and to multilateral development institutions which are: i. provided by official agencies, including state and local governments, or by their executive agencies; and ii. each transaction of which: a) is administered with the promotion of the economic development and welfare of developing countries as its main objective; and b) is concessional in character and conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)[1]."

Box 1: The concessional loan: a tool to promote development

Beyond the criteria for determining whether a loan qualifies as assistance to the recipient country, there is a basic question regarding the role of concessional loans in development financing. The developing countries' sovereign debt crisis in the late 1990s–followed by a major international initiative to grant debt relief to the heavily indebted poor countries (HIPCs)–triggered intense discussions on the role of this instrument in countries' economic and social development.

In the poorest countries, the low level of national saving and the weakness or absence of an efficient intermediation process[a] make it hard to finance productive investment. Moreover, from an external standpoint, access to liquidity is generally very restricted. In 2013, the 48 least developed countries (LDCs) identified by the United Nations captured less than 1% of world FDI[b]. The lack of private investors who could contribute to financing the economy has been abundantly documented in the economic literature. It is argued that the limited access to international financing is largely due to the perceived or actual risk involved in project financing or bond purchases, with the long-term commitments these actions entail. This is despite the fact that the returns on investment and capital should, in theory, be higher than elsewhere[c]. The observation of financing conditions for developing countries shows that, when they have access to the bond market in foreign currency, the maturity of their issues seldom exceeds 10 years. By comparison, ODA loans, with average maturities of around 30 years and average interest rates of under 2%[d], represent a highly preferential flow of resources to recipient countries.

A development assistance loan policy offers undeniable economic, social and environmental advantages for the recipient. However, it must be implemented with caution. Before financing is granted, a set of sectoral and macroeconomic criteria must be taken into account. For this purpose, the international community promotes the principle that concessionality of long-term financing should be adjusted according to two cross-sectional parameters: (1) the recipient country's development level (the poorer the country, the greater the concessionality required, all other things being equal); (2) the intervention sector (social sectors should enjoy greater concessionality than sectors that are economically more profitable, where concessionality can be low or even zero)[e]. The macroeconomic situation should also be systematically taken into account for loan transactions, so as to avoid situations where debt sustainability becomes problematic[f]. The debt sustainability analyses (DSAs)[g] conducted by the IMF and World Bank assess the sustainability risk for a country's debt on a scale ranging from "low" to "moderate", "high" or even "over-indebted". By incorporating DSA results in the donors' lending process, financing flows can be confined to countries whose public-finance position is deemed sufficiently sustainable. Lastly, ODA loans should not substitute for the growth of private entrepreneurship and restrict private investment. On the contrary, the goal is to create the conditions that will allow the private sector to begin an endogenous development process[h].

a. See, for example Bertho, F. (2014), "Renforcer les systèmes financiers des pays d'Afrique pour financer le futur agenda du développement durable", *Revue d'économie financière* no. 116, December. One of the phenomena observed is a negative correlation between (1) the developing countries' income level and (2) the saving rate and domestic credit to the private sector. In many African economies, the savings market is excessively channelled towards the financing of the State, perceived as the safest investment.

b. Approximately $25bn of FDI to LDCs versus more than $1,700bn of FDI at global level (source: World Bank Development Indicators). ODA remains the largest source of external financing for the LDCs.

c. See Lucas, Robert E. (1990), "Why Doesn't Capital Flow from Rich to Poor Countries?" *American Economic Review* 80, pp. 92-96.

d. See Guscina, A., Pedras, G. and Presciuttini, G. (2014), "First-Time International Bond Issuance: New Opportunities and Emerging Risks," IMF *Working Paper* no. 14/127, on the international borrowing conditions for developing countries and an analysis of recent bond issues; on ODA loan financing conditions in recent years, see Puppetto, L. (2016), Concessional finance and ODA reporting of long term financial instruments, *Documents de Travail de la DG Trésor* [Working Paper, in English], no. 2016/01.

e. See Report of the Intergovernmental Committee of Experts on Sustainable Development Financing, United Nations, 2014, pp. 29-31.

f. To allow for the recipient country's vulnerability to potential external shocks, one can also envisage loans whose repayments are adjusted to the economic cycle. The French Development Agency (AFD), for example, has created "counter-cyclical" loans with a suspensive clause in the event of a negative economic shock. Such flexibility allows a country to adjust its repayment schedule to its reimbursement capability consistently with the loan terms.

g. See, for example, www.imf.org/external/pubs/ft/dsa/lic.htm.

h. See Cohen, D., Jacquet, P. and Reisen, H., (2006), "After Gleneagles: what role for loans in ODA?", OECD Development Centre, *Policy Brief* no. 31, for an interesting review of the literature and an analysis of the macroeconomic impact of concessional loans on developing countries.

(1) See the DAC directives, www.oecd.org/dac/stats/documentupload/DCD-DAC(2013)15-FINAL-ENG.pdf.

The OECD's DAC directives are frequently discussed by Member States and regularly updated. The recording and classification of ODA loans has always been a delicate issue. In particular, ODA concessionality has been debated continuously in the DAC since its definition in 1972, but that definition has remained unchanged for over 40 years[2]. A 1992 memorandum from the DAC secretariat on the review of the ODA concept notes that the 1972 agreement on the 25% grant element was a "major achievement", but that the relevance of this approach had never ceased to be questioned[3]. The creation of the euro area in 1999 improved the financing terms set by the main EU donors; the 2008 economic and financial crisis then led to a new decline in interest rates in the main advanced economies. As a result, the 10% reference rate has been increasingly challenged by non-governmental organisations[4], think-tanks questioning official development assistance policies[5], and several DAC donor members. The easing of financing terms by certain donors raised questions on the proper match between the DAC discount rate and global interest rates. In this context, the DAC High-Level Meeting of 4-5 December 2012 stressed the need to clarify the rules for recording a loan as a part of the ODA effort. Ministers and agency heads requested a collective examination of a more "quantitative" definition of concessionality[6]. As the usefulness of the loan instrument was sometimes challenged by donors that do not use this financing tool, and as the uniform 10% discount rate adopted in 1972 appeared obsolete, the Ministers vowed to find a solution to modernise the system by 2015.

As a result, the OECD departments–in particular the DAC Secretariat–worked to develop material for the review in 2013-2014. Experts were called in, and Member States contributed in different ways: responding to DAC secretariat proposals in formal meetings of permanent DAC member countries at the OECD[7]; taking part in meetings of the DAC Working Party on Development Finance Statistics (a technical group comprising national experts, meeting at least twice a year; the French Directorate for the Treasury [DG Trésor] prepares these meetings and represents France); and disseminating proposals and working papers to feed the discussions.

In this connection, the DG Trésor proposed a working paper to contribute to the September 2014 review. The document was presented and discussed at DAC meetings at the OECD and at European Union level (The European Commission organises coordination meetings between Member States. It actually plays a dual role in DAC: as coordinator of its Member States which are also DAC members, and as donor in its own right for its activities and those of the European Investment Bank [EIB])[8].

Given the complexity of the subject, the DAC chairman, Erik Solheim, asked a high-level personality to convene a small group of DAC members interested in the issue and to formulate proposals so that a decision could be made before 2015. The personality chosen was Mark Lowcock, Permanent Secretary for the Department for International Development (DFID) of the United Kingdom. The group headed by Lowcock–comprising the United States, Sweden, Belgium, Germany, Japan, the European Commission and France–held several meetings between September and December 2014.

On the basis of the work conducted under Lowcock's chairmanship, DAC members accordingly agreed in December 2014 on new rules for measuring loan concessionality. Previously, a 10% reference interest rate was used to assess the concessionality (or "grant element") offered to the recipient country when it took out a loan on favourable terms with a DAC Member State. To qualify as ODA and so be included in the calculation of a donor's assistance to a developing country[9], a loan had to comprise a grant element of at least 25% of its face value[10]. For a given grace period, a loan's grant element is all the larger as the interest rate is low and the maturity is long. The chart below illustrates the change in the grant element (on the y-axis) of a loan as a function of the interest rate, varying between 0 and 3% here, and the date of the final repay-

(2) Führer, H. (1996), The Story of Official Development Assistance, OECD/GD(94)67.

(3) DAC Secretariat Note, "Review of the ODA concept" (1992).

(4) Aid reform must pass the development effectiveness test (Concord, July 2014); Colin, S. (2014), A matter of high interest: Assessing how loans are reported as development aid (Eurodad, January); Data report (ONE, 2014).

(5) Roodman, D., Straightening the Measuring Stick: A 14-Point Plan for Reforming the Definition of Official Development Assistance (ODA) (CGDEV, 2014).

(6) See the communiqué of the DAC High-Level Meeting (HLM) at ministerial level, 4-5 December 2012: www.oecd.org/dac/HLM%20Communique%202012%20final%20ENGLISH.pdf.

(7) The DAC meets approximately once a month at permanent representative level, sometimes more often during negotiation periods.

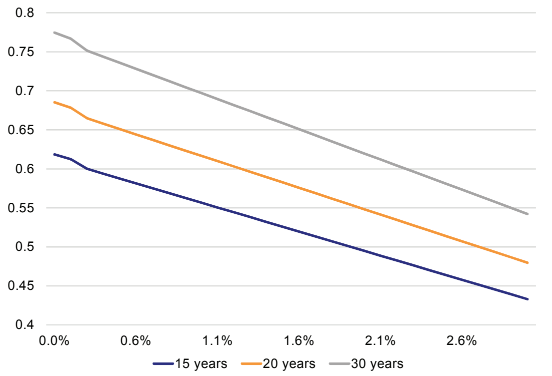
(8) See Puppetto, L. (2016), Concessional finance and ODA reporting of long term financial instruments, *Documents de Travail de la DG Trésor* [Working Paper, in English], no. 2016/01.

(9) Defining and measuring assistance is important for several reasons, including: to monitor ODA flows; to provide recipient countries with better information; to allow international comparisons between donors; to promote international standards for ODA implementation; and to ensure transparency in financing.

(10) This rule concerned only "untied" assistance loans, i.e., to finance projects awarded by international tender. Tied financing is subject to stricter eligibility conditions than untied financing (see Export Credits Arrangement, chap. 3, www.oecd.org/tad/xcred/theexportcreditsarrangementtext.htm). To qualify as ODA, a tied assistance loan to a lower-middle income country must comprise a 35% grant element, measured by differentiated discount rates (DDRs). These are revised annually by the OECD. They are based on average sovereign bond interest rates and the instrument's maturity and currency. They also include a premium of 100 basis points. The euro DDR in effect for 2014 for maturities of over 8.5 years was 3.7% (www.oecd.org/tad/xcred/2014-ddr.pdf).

ment (15/20/30 years). The "grace period"–the period between the first disbursement and the first repayment of principal–is set at 6 years here. This interval is also taken into account in determining the grant element; an extension of the grace period increases the grant element. The chart shows the negative relationship between the interest rate and the grant element emphasised above: for a 30-year loan with a 6-year grace period, a one-point increase in the interest rate lowers the loan's grant element by approximately 7 points.

Chart 1: Grant element of a loan as a function of the interest rate, for loans with 15-, 20- and 30-year maturities (calculated with a 10% discount rate)



Source: DG Trésor calculations.

1.2 The new agreement of December 2014 ensures greater consistency in the assistance reporting system: only grant equivalents will contribute to determining the assistance provided by ODA loans

In the current system, disbursements of an ODA-eligible loan–i.e., comprising a grant element of 25% or more–are reported as 100% of the principal paid, whatever the size of the grant element. Accordingly, a loan with a 25% grant element is reported in the same way as a loan with an 80% grant element. The 25% minimum for the grant element is a threshold that makes no allowance for loan diversity, which depends on criteria such as the category of the recipient country and the types of projects funded. When the loan is repaid, the donor reports the principal received as a negative contribution to the amount of assistance provided. As a result, the sum of the ODA contributions of a donor's loan over the loan's life is zero[11]. This raises a fundamental issue. In the long run, the donor's effort in making resources available as soft loans to developing countries–in other words, financial resources that the countries could not obtain from the markets and are used, for example, to carry out infrastructure projects–is not registered at all in the statistics measuring donors' contributions, as it is equal to zero[12].

The December 2014 agreement provides for a reporting of loans in grant equivalent terms. The grant equivalent, expressed in monetary terms, is equal to the "subsidy" value associated with an instrument and calculated as a function of its preferential terms. For a loan[13], the grant equivalent is the nominal amount multiplied by the grant element. It is calculated using a reference interest rate, also called "discount rate", under which the loan's financial terms are deemed preferential (the grant equivalent will, in that case, be greater than zero). For a €100m project funded with a loan comprising a 50% grant element, the assistance recorded as a disbursement will now be €50m rather than €100m. If the donor agrees to an additional effort to raise the loan's grant element to 70%, for example, the donor's account will be credited with €20m in additional assistance, for a total €70m. The softer the loan terms, the greater the assistance reported by the donor, which will help to raise its ODA/GNI (gross national income) ratio, all other things being equal. Donors therefore have an incentive to grant softer loan terms, strengthening debt sustainability (the net current value [NCV] of the flows decreases). The ODA over the loan's life will not be zero, as before, but will equal the donor's effort to "subsidize" the loan.

2. A single discount rate that does not take partner countries' specific characteristics into account can generate distortions in loans allocation

The disadvantage of a single discount rate is that it does not take the donor country's development level into account. By imposing a single reference rate for all countries, the same assistance loan is reported at an identical value regardless of whether it is granted to an upper-middle income country such as Brazil, Mexico or Jordan, or to a country classified by the UN as a least developed country (LDC) such as Burkina Faso or Mali. But the financing of a long-term project in an LDC is (1) more expensive for the donor (because of stricter prudential rules and a higher average credit risk[14]) and (2) far more complex to implement and monitor on the ground (because of the need for technical assistance to strengthen the project owner's supervision, the deployment of costlier and more complex manpower, and so on). The main defect of the previous systems for measuring concessionality was its incorrect recording of the financial cost of ODA project financing–a situation that may, to some extent, have incited donors to select projects situated in relatively less "difficult"

(11) Interest repayments are not included in the determination of ODA generated by loans.

(12) For example, a loan that has received a total subsidy element of €100m towards softening the loan terms, provides the donor with a zero long-term assistance value-according to current ODA statistics, prior to the December 2014 reform.

(13) Or any other form of resource flow. The grant equivalent of a €100 gift is thus equal to the value of the gift, i.e., €100, and the grant element of a gift is 100%. In theory, one can calculate the grant elements of all concessional instruments by comparing them with their market value. In practice, not all concessional instruments necessarily have a corresponding market reference value, so one needs to proceed by approximation.

(14) See, especially, table 2 below for estimates of average risk premiums by country category.

geographic areas. One of the patterns observed in recent years is a greater concentration of ODA in middle-income countries (MICs) rather than in LDCs and other low-income countries (LICs). On average, of the $137bn in loans granted by DAC members in 2006-2013, 12% went to LDCs and other LICs, 57% to lower-middle income countries (LMICs) and 22% to upper-middle income countries (UMICs)[15]. This weaker concentration of bilateral concessional loans in LDCs and LICs is also due to the very shallow depth of these economies, which offers comparatively fewer project financing opportunities.

2.1 The agreement reached at the December 2014 High-Level Meeting (HLM) replaces the 10% discount rate by three discount rates, differentiated according to the recipient's income category

The three rates apply to three categories of countries based on the list of assistance recipient countries, defined and updated periodically by the DAC[16]: LDCs and LICs, LMICs, and UMICs. The rates will make it possible to calculate the grant element of all long-term financing flows to a developing country according to its category. These discount rates are defined far more clearly than the former single rate. They will be determined by the donors' financing terms, as measured by the reference rate applied in the IMF debt sustainability and debt limits[17], plus a risk premium set in accordance with the recipient country's category: 1% for UMICs, 2% for LMICs, and 4% for LDCs and LICs. The risk premiums will be reviewed as needed. They reflect the fact that it is on average financially riskier, and therefore costlier, to lend to poor countries than to rich ones. Most important, by pegging the premium to the income level, the agreement will enable a donor, for the same loan, to record more assistance if the loan is granted to an LDC or LIC than to a MIC. This change in the incentive structure should lead donors to rebalance their loan portfolios, when possible, towards the funding of sustainable development projects in the poorest countries. This change in the incentive structure may contribute, to some extent, to help reach the goal–set by many donors–of devoting 0.15-0.20% of gross national income (GNI) to LDCs[18] in the form of Official Development Assistance.

Table 1: Parameters adopted in the December 2014 agreement on concessionality of instruments (financing terms, risk adjustment factors and minimum concessionality thresholds)[a]

	LDCs and other LICs	LMICs	UMICS
Donors' financing terms, taken as equal to the discount rate prevailing in the IMF *(i)*	5%	5%	5%
Adjustment factor (risk premium) *(ii)*	4%	2%	1%
Discount rate *(i)* + *(ii)*	9%	7%	6%
Minimum concessionality element - threshold	45%	15%	10%

a. See www.oecd.org/dac/OECD%20DAC%20HLM%20Communique.pdf, Annexe 2.

Source: DG Trésor.

(15) It should be noted that 2% of bilateral loans issued during the period are regional and cannot be assigned to a specific category of country (source: DAC statistics).

(16) Eligibility for assistance essentially depends on per capita income. Eligible countries are classified into the following categories: (1) least developed countries (LDCs) (list prepared by the United Nations and based on income criteria but also on structural components linked to the concept of fragility, and "human" components such as the human development index [HDI]), (2) low-income countries (LICs), (3) lower-middle income countries (LMICs), and (4) upper-middle income countries (UMICs). See www.oecd.org/dac/stats/daclist.htm.

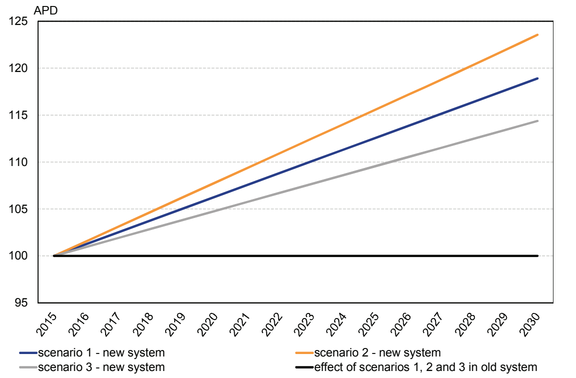
(17) See "Unification of discount rates used in external debt analysis for low-income countries" (IMF 2013, pp. 9-11, www.imf.org/external/np/pp/eng/2013/100413.pdf).

(18) Target set in 2001 with the adoption of the 2001-2010 United Nations LDC action programme. The target was reconfirmed, first at the 2011 conference on LDCs in Istanbul, then in the Addis Ababa Action Programme adopted at the end of the international conference on development financing, 16 July 2015. In its conclusions to the Foreign Affairs Council of 26 May 2015, the EU undertook to achieve the 0.15% target "in the short term" and the 0.2% target within the time frame of the post-2015 development agenda.

Box 2: **Simulation of ODA impact of a reallocation of concessional loans in favour of LDCs and LICs under the new reporting system**

Chart 2 shows the ODA impact of a reallocation of a portfolio of concessional loans in favour of LDCs and LICs, for given volumes and financing terms. We examine several adjustment scenarios: (1) a reduction in the share of loans to UMICs and LMICs; (2) a reduction in the share of loans to UMICs only; (3) a reduction in the share of loans to LMICs only. To illustrate the incentive effects of the reform, we apply the same financial parameters to all loans[a], irrespective of recipient category (in practice, we observe more favourable terms, on average, depending on the recipient's income, with LDCs recording the highest concessionality levels). When a single discount rate (black line) is applied, the ODA resulting from a portfolio rebalancing remains identical under all scenarios. The ODA does not reflect the rise in costs or "effort" for the donor from working in complex geographic areas, despite substantial portfolio adjustment costs in all three scenarios[b]. By contrast, with risk-adjusted discount rates, any reallocation towards countries in lower-income categories leads to an increase in ODA. The increase is all the steeper because of the adjustment, which reduces the share of concessional loans to the highest-income developing countries (scenario 2). The impact is milder if the rebalancing towards the LDCs and LICs is achieved solely by reducing the share of loans to LMICs, leaving the share of loans to UMICs unchanged (scenario 3). With the discount rates adopted at the 2014 HLM, and using such simplified modelling assumptions, a complete reallocation of the bilateral concessional loan portfolio of all DAC donors towards LDCs would raise donors' ODA recorded as concessional loans by over 20% for identical financing volumes[c]. These simulations are purely illustrative and do not take certain factors into account, such as recipient countries' absorption capacities and the existence of a store of "bankable" projects in the LDCs.

Chart 2: ODA en haut de l'axe des ordonnées



Source: DG Trésor calculations.

Note: For illustration purposes only, we simulate the ODA impact of a 2.5-point annual increase in the share of loans to LDCs and LICs, reaching 50% of the total volume of loans committed. The lagged effect of disbursements is not taken into account.

Simulation parameters: In the initial year, the portfolio breaks down as follows: LDCs and LICs 12.5%; LMICs 55%; UMICs 33%. These values are close to those observed empirically. We simulate an annual rise of 2.5 percentage points in LDCs and LICs loan outstandings, with three distinct effects on the portfolio:

- Scenario 1: (blue line): annual reduction of 1.25 points in UMIC loan outstandings, annual decrease of 1.25 points in LMIC loan outstandings.
- Scenario 2: (orange line): annual reduction of 2.5 points in UMIC loan outstandings.
- Scenario 3: (grey line): annual reduction of 2.5 points in LMIC loan outstandings.

a. Grace period: 6 years; maturity: 30 years; interest rate: 3.5%. These parameters are compatible with the three new concessionality thresholds.

b. In the present system, the rise in costs does not entail a rise in ODA. It should be noted that the cost of portfolio rebalancing also depends, among other factors, on minimum concessionality thresholds.

c. This figure is calculated as follows: (1) we assume a system that calculates the ODA value of loans in grant-equivalent terms, and (2) we compare the impact of a reallocation of all concessional loans to UMICs towards LDCs and LICs, between a system with a single discount rate (no change) and the system with three discount rates adopted in December 2014. In other words, this calculation does not reflect the ODA impact of a switch from flow-based reporting to grant-element-based reporting, but only the impact of the discount-rate revision. A simulation of the improvement in loan terms linked to the recipient's income-using historical data-shows that the increase could reach 30%.

2.2 The technical parameters adopted in December 2014 are far more restrictive than those estimated by analysing developing countries' capital market access conditions

Furthermore, with respect to the current system, these parameters imply a tightening of the financial terms that donors must meet to make their financing ODA-eligible. As a result, some loans previously reported as ODA–the least concessional–will no longer qualify as ODA. In practice, this will contribute to the sustainability of developing-country debt.

By comparison with risk premiums calculated from market data and sovereign bond issues, the premiums adopted in December 2014 do not reflect the full credit risk posed by recipients, particularly the LDCs. The table below gives an order of magnitude of the difference, showing that DAC members have accepted an assessment of loan concessionality on stricter criteria than those estimated in other systems. Measured by the chosen discount rates, a loan becomes concessional merely by being issued on far softer terms for the recipient than the terms on which these States finance themselves. While the risk premiums adopted at the outcome of the negotiation on the agreement obviously reflect a political compromise, the discussion was fuelled by analyses of financial conditions prevailing in developing countries. For example, Senegal, a country classified as an LDC, was able to borrow $200m at 9.25% over 5 years in 2009, whereas the discount rate set for this country category is 9%. Moreover, most LDCs and LICs are unable to raise funds on the financial markets. An LMIC such as Ghana borrowed $750m at 8.5% in 2007, for a 10-year maturity, and $750m at 8% for 10 years in 2013, compared with the 7% discount rate set in the agreement. Gabon issued $1.5bn in 10-year bonds at 6.38% in 2013, as against the 6% discount rate adopted in the December 2014 reform for the country category to which Gabon belongs. To compare the degree of ODA loan concessionality with market conditions, it is essential to take maturity into account. Most developing countries are unable to finance themselves at maturities of over 10 years, whereas the average maturities of ODA loans are far longer, on the order of 20 or 30 years.

Table 2: Donors' effort under the December 2014 agreement: comparison of risk premiums adopted with premiums estimated empirically

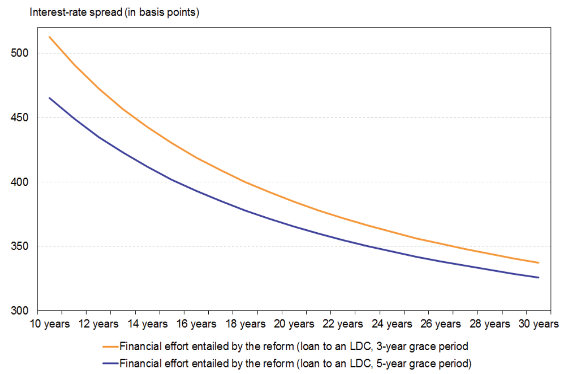
	LDCs and other LICs	LMICs	UMICs
10-year risk premium, empirical estimate [a] *(1)*	8.7%	6.3%	3.4%
Risk premium, 2014 agreement *(2)*	4%	2%	1%
Spread *(1)* - *(2)*, in basis points	470	430	240

a. See Puppetto L. (2016), "Concessional finance and ODA reporting of long-term instruments", *Documents de travail de la DG-Trésor* n°2016/01.

Source: DG Trésor calculations.

In other words, the risk-adjustment factors (or "risk premiums") adopted at the outcome of the negotiations on concessionality reform at the OECD's DAC in December 2014 are lower than the risk assessments for each country category based on developing countries' sovereign bond issues, when they exist. For example, for the least developed countries and low-income countries (LDCs and LICs in Table 2 above), the risk premium adopted in the agreement is 470 basis points below the observed 10-year risk premium.

Chart 3: Additional financial effort entailed by the reform for loans to LDCs and LICs



Source: DG Trésor calculations.

How to read this chart: the chart above shows the additional financial effort required for a loan to an LDC or LIC to qualify as ODA under the December 2014 reform versus the former system for measuring concessionality. The financial effort is expressed as an interest-rate spread and depends on the loan maturity and grace period. For a 25-year maturity and a 5-year grace period, with a 9% discount rate and a 45% minimum grant element, the additional financial effort represents approximately 350 basis points of interest rate.

The downward revision of the discount rates and the introduction of differentiated concessionality thresholds also implies a toughening of the financial terms required for a loan to qualify as ODA. To assess this additional effort, one must compare the three thresholds and discount rates chosen with the current 25% minimum threshold, calculated with a 10% discount rate. For the same loan, with a given maturity and grace period, the maximum interest rate required to make the financing qualify as ODA is lower–in every instance–than the rate currently required. This is particularly true for the LDC and LIC category, for which donors will have to double their financial effort if they want to report their loans as ODA to the OECD. This decision should be noted as a contribution by DAC donors to the United Nations' new sustainable development agenda.

2.3 The "safeguard" provisions of the reform, combined with a prudent loan policy by international donors, will contribute to debt stability and sustainability for the developing countries, particularly the poorest

The agreement obtained at the DAC ministerial meeting of December 2014 includes "safeguard" provisions to complement the "incentive" provisions described above.

First, it stipulates that concessional loans reported by donors to the DAC will be included in the calculation of the assistance ratio only if their terms comply with the debt limits policy in effect at the IMF and/or under the World Bank's non-concessional borrowing policy. These rules–promoted by the international community for the past several years–foster sustainable debt dynamics in countries where an IMF programme is in force, as well as in countries that have recently exited a programme. For example, in a country such as Burkina Faso, where an IMF/World Bank programme is being implemented, tighter concessionality rules have been imposed: a 35% minimum concessionality threshold with a 5% discount rate[19]. In compliance with these debt limits, France extended a 15-year loan to Burkina Faso in 2012 at a 0.76% interest rate. The grant element, measured with a 9% discount rate, exceeds 50%. The funds are intended to strengthen the interconnection of the country's power grid. While most donors were already complying with these conditions, the safeguard provisions are a valuable step forward that should offer both present and future DAC members a greater incentive to take account of the debt sustainability framework promoted by the IMF and World Bank in their bilateral loan policy. The IMF and World Bank rules on sustainable financing are thus "added"–when countries are subject to them–to the DAC/OECD rules for calculating concessionality. Donors' bilateral loans must therefore comply with IMF and World Bank constraints on the one hand, and those of the DAC/OECD on the other. The Addis Ababa Action Agenda adopted at the Third International Conference on Financing for Development in July 2015 recognises this change, which will contribute to promoting the principle of sustainable development financing.

(19) See especially www.imf.org/external/pubs/ft/dsa/dsalist.pdf.

Second, to prevent a loan with an abnormally high interest rate from being issued to an LDC or LIC and being reported as ODA, it has also been decided that no loan to these countries with a grant element of less than 45% would qualify as assistance. This tightening of eligibility criteria will contribute to debt sustainability for the poorest countries (LDCs and LICs), which will enjoy even more favourable financing terms from bilateral donors than before (see Chart 3 for a simulation of the additional financial effort entailed by the reform).

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