

Giving Credit Where Credit's Due - The Need to Address Flaws in the Calculation of ODA in Loans

Q&A with Stephen J. Cutts

Questions:

- 1. Is the new "grant equivalent" system for calculating ODA in loans an improvement over the previous cashflow method?**
- 2. What's the difference between concessionality level for tied aid loans and grant element in ODA loans?**
- 3. Why not use the IMF base factor of 5% for tied aid loans, rather than converge on the DDRs?**
- 4. Should there be different discount rates for countries within the Eurozone?**
- 5. What is the basis for claiming the treatment of debt relief is "double counting"?**
- 6. What if the discount rate adjustment for risk is inadequate to cover losses?**
- 7. Can it be justifiable to apply the same discount rates to loans to countries with very different credit risks?**
- 8. Is it problematic that low interest loans no longer appear concessional?**
- 9. Should the export credit work on credit risk inform the assessment of risk for ODA loans?**
- 10. Is the credit risk higher for ODA loans with long repayment periods?**
- 11. Are the export credit risk premiums adequate to cover the risks?**
- 12. Is there a risk that this could become too complex and administratively burdensome?**
- 13. Does the new system create winners and losers among lenders?**
- 14. What about the "borrower perspective"?**
- 15. What are the most distortive flaws?**

16. Is this an attack on the OECD?

17. Why does this matter?

18. What would be the benefits of change?

19. Why is this so urgent?

20. Shouldn't we focus on more than ODA in considering development?

21. If the DAC isn't the right body to take this issue forward, why are you writing to its Chair?

1. You are highly critical of the Grant Equivalent system of calculating the ODA in loans, yet surely it is an improvement over the previous cashflow model?

The move to a system where only the grant element of a loan counts as ODA was absolutely the right thing to do. And both lowering and differentiating the discount rate compared to the previous flat 10% was also a move in the right direction.

However, paradoxically, the DAC has created a situation where “two rights make a wrong”! By counting the grant element/equivalent as ODA under the new methodology, it is essential that the discount rate is close to the costs for the lender in providing the loan. Under the old system, the 10% discount rate was only relevant for clearing the hurdle of reaching the minimum grant element of 25%. It was not used for calculating the ODA being given (as the full-face value of the loan was counted, and then repayments of principal over time were counted as negative ODA). So, to some extent, it mattered much less that the discount rate was set too high.

In the new system, the discount rates matter far more – as they are “baked in” for the calculation of ODA. If they are too high (which they clearly are) this has a massive impact on the ODA that is counted, allowing donors to claim they are providing huge amounts of aid...when the reality is that the donor effort is small, non-existent or even negative (see the loan examples in the paper and annex). And loans, which formerly counted as zero ODA once they were repaid (regardless of the softness/generosity of their terms), are now incentivised over grants for donors whose cost of funds is below the discount rates being used by the DAC.

2. Why does the OECD use different discount rates for calculating the concessionality level in tied aid and the grant equivalent in other aid loans? Aren't they essentially the same thing?

Yes – both systems should be measuring donor effort, in terms of the net cost to the donor's budget. The reason why the grant elements used are so different is because the methodologies have been designed and agreed by different OECD committees from different government ministries with different objectives¹. The aim of the OECD Governments who comprise the Participants to the Export Credit Arrangement in establishing the Helsinki Tied Aid Disciplines was to guard against governments providing small subsidies that give their own exporters a competitive advantage. Accordingly, in this area, OECD is incentivised to ensure that the discount rates used accurately reflect the real costs of borrowing for first-class borrowers. If the discount rate were significantly above these real cost levels (say at the level of 5%), it would be possible

¹ Though interestingly, the respective memberships of the DAC and the Export Credit Arrangement are virtually identical. Only one DAC member (New Zealand) is not an export credit “Participant” and only one Participant (Turkey) is not a member of the DAC

for governments to offer significant “sweeteners” to win contracts at little or no cost to the taxpayer.

The DAC on the other hand, comprising the donor community, is incentivised to make their ODA contributions look as generous as possible. And the impact of very high discount rates does just that, by massively inflating the so-called “grant equivalent” above the costs of providing the loan.

3. You imply that the discount rates used for calculating the ODA in loans should converge with the discount rates published by the OECD for the purpose of calculating the concessionality level of tied aid loans. Why not the other way round: suggest that the DDRs be abandoned in favour of a simple discount rate of 5% as the IMF uses?

I understand that there are efforts, from some European countries, to persuade other OECD Governments to adopt the 5% discount rate in place of the DDRs for the purpose of calculating the concessionality level of tied aid. Although, perhaps, beyond the scope of this paper, this would be a mistake in my view. Such an approach would enable tied aid loans to be extended at little or no effort for many donors and undermine the purpose of the Helsinki Disciplines to prevent aid being used to distort competition. In lowering donor effort in providing tied aid, one would expect tying to increase. From a developmental perspective, the DAC has argued convincingly that tied aid represents far lower value for recipient countries than untied aid. So such a move would be bad for fair competition and bad for development!

Why converge with the DDRs? Because the differential discount rates are much more closely aligned to the actual funding costs of donor governments than the current flat 5% for all currencies and therefore ensure that the ODA counted in loans is a much more accurate approximation of donor effort/cost to taxpayer.

4. Having just one DDR for the Euro implies that the funding costs of all countries using the currency are similar. Is this right?

This is almost certainly not right. At the time of the debt crisis, the difference in borrowing costs among countries using the single currency varied significantly. While spreads have narrowed considerably since that time, it would seem appropriate to apply discount rates based on the bond yields for individual countries that use the single currency rather than a common discount rate based on the yields of bonds issued by the ECB. This is an issue that should be taken up by the independent organisation or experts’ group recommended in the paper.

5. I still don't fully understand the "double counting argument" that it's not legitimate to both include a credit risk spread in the discount rate and charge the costs of debt relief as additional ODA. Are you 100% sure this is wrong?

I'm 200% sure (sorry, couldn't resist that joke!). Let's imagine a scenario where a country gives 10 loans, each of \$1 million on 1 January to 10 different countries. Each is repayable in full by a single bullet repayment on 31 December the same year. The risk of non-repayment is 10%...in other words one of the loans is expected not to be repaid. So here's the conversation:

Lender: Hey, DAC, I'm putting \$100,000 aside from each of the loans to pay for the loss I expect from my loan portfolio...so that's \$1 million in total. Can I count this as ODA?

DAC: OK

At the end of the year, as expected, one of the loans has to be forgiven.

Lender: Hey, DAC, you know that I set aside \$1 million to pay for expected losses at the start of the year, well one of the loans hasn't been repaid. Can I claim another \$1 million in ODA for this, even though I set aside the money to cover this loss and it's already been counted as ODA?

DAC: Yes, but just deduct the \$100,000 you already counted as ODA for the credit risk on that loan.

So the donor effort has been \$1 million, yet \$1.9 million of ODA is claimed. Double counting!

6. Very funny, but what if, as the DAC claims, the risk spread in the discount rate is inadequate to cover the losses?

Firstly, a comparison with the long-term export credits premium rates suggests that the risk spreads applied by the DAC are higher than needed to cover the risks of non-repayment². But, for the sake of argument, let's replay the DAC conversation only at the end of a second year of providing these 12-month loans.

Lender: Hey DAC, I did exactly what I did last year and set aside \$1 million to pay for losses but guess what! This year, TWO loans weren't repaid, costing me \$2m. Can I claim this \$2 million as ODA in addition to the \$1 million I set aside at the start of the year and counted as ODA?

DAC: Hang on a minute, if you are going to count all your losses as ODA when you have them, why don't you stop counting the \$1m you claim to be putting aside at the beginning of the year

² Notwithstanding the under-pricing of risk for some recipient countries and the overpricing of others due to the use of World Bank Income categories to assign risk – see flaw 3 in the paper.

as ODA? After all, you're telling me that you're not using that to pay any of the claims. And given you are counting your losses of \$2 million at the end of the year as additional ODA, you are already accounting in full for your donor effort. Doesn't that make sense?

Lender: Errrr, yes, but that way I don't look as generous. Maybe if I just don't count the \$100,000 I set aside for each of the loans that went bad, like last time, I can claim I'm not double counting and don't claim more ODA than if I'd given the loans as grants.

DAC: So, instead of claiming \$2 million for a single loss of \$1m in year one, you only claim \$1.9m as ODA? And in year 2, instead of claiming \$3 million for losses totalling \$2 million, you only claim \$2.8 million. So despite the fact that the donor effort/cost to the tax payer of all the losses for the two years combined is \$3 million, you want to claim \$4.7m ODA? OK - seems reasonable!

7. Surely it can't be justifiable to apply the same discount rate to loans to developing countries with very different repayment risks? A commercial lender would never do this.

This is absolutely what a commercial lender would do if it did not have to price the credit risk. In fact, this is what happens when, for example, UK Export Finance or US Eximbank extend a 100% unconditional guarantee for a loan. By taking away the credit risk, the commercial lender can offer the same interest rate regardless of the borrowing country. Of course, in these circumstances, the WTO requires that premium fees are paid that reflect the different levels of risk. In the case of an ODA loan, if a donor aid agency knows that any debt relief losses are going to be "funded" separately by the ODA budget, there is no need to adjust the discount rate for credit risk.

8. I've just used the DAC calculator to calculate the grant element of a 10-year loan in Euros to a UMIC using the DDR of 1.3%, and it can't meet the minimum grant element of 10% required to be considered as ODA, even with a zero interest rate. That can't be right?

It is right. This shows starkly that the donor effort/cost in providing even a zero interest rate loan really isn't very high. Having said that, moving to using significantly lower discount rates to calculate grant elements/equivalents may lead to a review of the current "hurdle" rates³ of 10% for UMICs, 15% for LMICs and 45% for LICs. Of course, in the example you give, it would be possible to meet the minimum grant element requirement if the loaner were to accept that less than the full-face value of the loan needs to be repaid (i.e. apply a negative interest rate to the loan), and/or offer other generous terms, such as a long grace period.

³ These are the minimum grant element amounts for a loan to qualify as ODA

- 9. You suggest that the credit risk part of the discount rate, could use the country risk classifications of the Export Credits Arrangement. Yet the OECD website says explicitly that “They are produced solely for the purpose of setting minimum premium rates for transactions supported according to the Arrangement...Neither the Participants to the Arrangement, nor the OECD Secretariat, endorse nor encourage their use for any other purpose.” Are you suggesting that this should be ignored?**

Yes. The outcome of this work is in the public domain and it is the product of a robust methodology, endorsed by senior country risk experts from OECD governments.

Producing country risk categories is highly sensitive work. It helps the OECD that the Participants to the Export Credit Arrangement is not, formally, an OECD committee. Of course, the DAC might find it difficult, politically, to use such information to calculate the ODA in loans to developing countries. But they would probably find it equally difficult to justify using the credit assessments of a commercial rating agency, such as Moodys, Standard & Poors or Fitch. There are two solutions:

- a) Continue to count the costs of debt relief as additional ODA, thereby negating the need for any risk spread in the discount rate
- b) Assign the responsibility for defining and counting ODA to an independent and competent body, which is not subject to the same political constraints (or control) as the DAC.

- 10. ODA loans can be for very long periods – doesn’t that mean the credit risk is higher as risks are unforeseeable and justify a higher discount rate?**

So long as the costs of debt relief are added to ODA, there is no justification in adding any credit risk spread to the discount rate. Leaving that aside, the premise that credit default risk increases over time is unfounded. Of course, the longer a loan period, the more chance there could be a default on that loan, but that does not mean that the risk of default in 2040, say, is any higher than in 2030. Indeed, surely we should expect the development community to be optimistic and assume that over the very long term their work will help to grow the economies of developing countries and make them more robust and able to withstand shocks. This would then reduce the risks of debt relief and suggest that any credit risk element of discount rate should be lower for loans with very long repayment periods!

- 11. Moreover, how do you know for sure that the export credit premium rates, on which you base some of your calculations, are adequate to cover the risks?**

It is never possible to be completely sure that losses won’t exceed expectations and inferred risk premiums/spreads won’t be inadequate to cover the cost of debt relief. However, there is a robust methodology behind these rates and the country classifications, as can be seen from the OECD’s published explanations of its work. The results are also monitored over time against

claims data to ensure their continuing validity, and they are adjusted as required. More fundamentally, the Governments of ALL DAC countries (except New Zealand, which is not an Export Credits Participant) have determined that these premium rates do comply with the WTO requirement that they be adequate to cover long term operating costs and losses.

12. Wouldn't a system using differentiated discount rates and (possibly) credit spreads based on country risk categories be too complex to calculate and to monitor?

Not at all – it's amazingly simple. The DDRs are published on a single page once each year and, should credit risk need to be added, it would be simple to check the country lists (also published by the OECD) to add the spread agreed for that category. It's a task that would take a matter of seconds! Management and monitoring would also be straightforward; after all, another part of the OECD already manages and monitors these same systems for tied aid and export credits.

13. The OECD reported that "the implementation of the ODA grant equivalent methodology [had] significant impacts on a few countries: Japan (+19%), Spain (+9%) and France (-11%)⁴. Doesn't this show that the new system has "winners" (i.e. Japan and Spain) and "losers" (France) among donors providing loans?

The "decline" in ODA for France is both illusory and transitory. Every lender gains under the new methodology. How could it be otherwise when every loan under the previous system counted as zero ODA by the time it had been repaid? Probably France took a temporary "hit" because it has extended new loans with a combined face value well above the repayments of principal it has been receiving on old loans. This would indeed count more highly under the old methodology, where the full-face value of the loan was counted as ODA rather than just the grant element. But under the new system, France's ODA counted today will not be eroded to nothing over future years as the loans get repaid, as each repayment of principal will no longer be counted as negative aid.

14. The paper looks at the issue from the lender/donor perspective, but what about the borrower/developing country perspective? Don't they get a benefit from these development loans even if the "costs" to the donor are being exaggerated?

The reason for taking the lender perspective is that this is the fair way to compare the donor effort in loans compared with grants – which is the DAC's stated objective. Indeed, the first line of the DAC's definition of ODA reads "*The ODA grant equivalent is a measure of donor effort.*" This also accords with the public's understanding of the international target of 0.7% of GNI target

⁴ <https://www.oecd.org/dac/financing-sustainable-development/development-finance-data/ODA-2020-detailed-summary.pdf>

for donor countries to provide for development: that this is the amount that their governments are expected to spend on development. As the UK Government reports⁵, the 0.7% is a “spending” target, NOT a beneficiary to recipient target.

The paper is not criticising the purposes, benefits or even the terms of the loans being provided. It simply argues that the ODA element needs to be calculated on a robust basis, and its current exaggeration is incentivising governments to provide loans instead of grants and enabling them to claim significant ODA for loans that have little or no donor effort.

A discount rate from the borrower perspective set at the interest rate they would face from a commercial lender (but minus the credit risk element – as long as the DAC allows debt relief costs to be counted as ODA) might be slightly higher, but for most currencies, it would still not be close to 5%. And, of course, any discount rate above the cost of funds, incentivises donors to provide loans instead of grants.

Incidentally, even if the borrower perspective were considered, this would not negate any of the flaws around the double counting of credit risk, counting debt write-off for non-development loans as ODA, etc. More importantly, it would not be consistent with the DAC’s stated aim of measuring donor effort and providing for a fair way to compare the ODA in loans and grants.

15. What in your view is the most distortive flaw?

The biggest problems are the 5% base element in the discount rate, which is much higher than the real funding levels for virtually all OECD donor governments, and the double-counting of the credit risk – once in the discount rate and again when debt relief is needed. Oh...and the counting of debt relief for non-ODA loans – that’s simply indefensible.

16. Your paper seems very critical of the OECD, an organisation with a reputation for sound economic analysis and robust international statistics. Is this warranted?

I hold the OECD Secretariat in the highest regard and spent more than a decade working in the organisation. It is staffed by the highest calibre of committed professionals, who work long hours and bring experience and dedication to their work that I have never seen surpassed elsewhere.

This is a very specific problem with the Development Assistance Committee which seems to have politicised the counting of ODA. The major flaws I have highlighted in the paper are mutually reinforcing in exaggerating the ODA in loans. It suggests that this Committee, comprising only donor community representatives, has yielded to the temptation to agree to a methodology that massively exaggerates the largesse and generosity of themselves as donors. As stated in the paper, even if you don’t think the DAC has an institutional conflict of interest in looking at this

⁵ <https://commonslibrary.parliament.uk/research-briefings/sn03714/>

issue given its membership, its actions have surely forfeited its authority to have stewardship of this issue going forward.

I should add that the previously flawed system of counting ODA existed before the Secretary-General I served (Donald Johnston of Canada) came into office, and the new flawed system was put in place before the current Secretary-General (the Australian, Mathias Cormann) took up his post. Neither can be held accountable for this system in any way.

17. Why on earth does this matter?

It matters because the public is being massively misled about the amount of aid their countries are giving. It matters because it drives donors to provide loans instead of grants saddling poor countries with debts they cannot afford to service. It matters because this is contributing to a massive global debt crisis. And it matters because it is helping developed countries to evade their climate change responsibilities: instead, they are making developing countries pay for cleaning up the mess of climate change that they did not cause, while the donor countries claim (falsely in many cases) that they are providing aid.

18. ...and what would be the benefits of the changes you propose?

In a nutshell: fairness; robustness; honest reporting to taxpayers; a removal of the financial incentive to provide loans rather than grants (so the likelihood of fewer loans being extended and more grants being given); and much softer terms in those loans that are given as would be required to register as ODA. Oh, and it might even contribute to a more equitable system for climate finance to help poorer developing countries cope with the costs of mitigation and adaptation to a problem they have not cause, and thereby play a small role in helping to save the planet.

19. Why can't this issue await the scheduled DAC review of its discount rates scheduled for 2023? After all that is just a year away.

Climate financing is such an urgent issue that this cannot wait until 2023. The issue will be brought to the fore again at COP27 in Cairo later this year, and this really will be a critical moment to either set us on a massively accelerated path of a low/no carbon future or see the world backsliding. What is currently happening in terms of highly indebted developing countries having to repay loans to combat a climate change they did not create, while OECD countries claim ODA for aid that they are not giving, is the antithesis of climate justice. Secondly, as noted in the paper, the international community really needs to think about whether the issue of defining and counting ODA can continue to be left to the donors' club of the DAC, given their composition and record of developing deeply flawed, self-beneficial, methodologies for assessing ODA in loans.

20. This paper focuses on what's counted as ODA, but surely financing for development (and indeed climate change) is much broader than this?

Absolutely, yes. ODA flows are very small compared with foreign investment and other financial flows to developing countries. But ODA matters, as it can help to leverage (or stifle) those broader flows. And it is needed for vital underpinning elements of the economy, such as health and education, where it is much harder to attract alternative finance as they do not, in themselves, offer significant financial returns.

ODA and climate finance are also of enormous political importance. It is much easier for the highly developed economies of the OECD, which have already achieved high standards of living, to manage the transition to a low/no carbon future and provide the necessary investment and economic incentives for such a future. This is much more difficult for developing countries, which may perceive that there is a trade-off between creating the economic growth to deliver their populations from poverty and moving away from a dependence on fossil fuels. Yet, an effective strategy to combat climate change and set the planet onto a sustainable future path, requires the whole world to act together, and to act quickly. Current practices around climate financing and, indeed, ODA only serve to undermine the trust needed in this regard.

21. Given you argue that the DAC isn't the right body to take this issue forward, why are you writing to its Chair?

Good question! It seemed like a good place to start. Moreover, I harbour some hope that she will either tell me that the DAC CAN fix this, and quickly, or that she will offer her powerful backing for moving the issue to a less conflicted forum. To be honest, neither of these responses are expected!