EUROPEAN INTERNATIONAL CONTRACTORS
Kurfürstenstrasse 129
D-10785 Berlin
Germany
Tel +49 (30)-2 12 86-244
Fax +49 (30)-2 12 86-285
info@eicontractors.de
www.eicontractors.de

EIC
EUROPEAN INTERNATIONAL CONTRACTORS

EIC Background Paper

"Modernising the definition for Official Development Assistance (ODA)"

Introduction.

The OECD DAC is currently in the process to redefine the ODA definition and investigate ways how private finance can be catalyzed for developmental purposes. With this paper EIC wishes to contribute to these important discussions.

In this paper the following topics are covered:

I. The definition of Official Development Assistance (ODA);
II. Importance of improved cooperation between development finance and Export Credit Agencies (ECAs);
III. Commercial viability test for untied aid;
IV. The list of countries eligible for ODA;
V. Complementary role of development finance;
VI. The aid activities of non-OECD countries.

EIC would like to highlight that its suggestions / recommendations described in this paper can also contribute to enhancing aid efficiency and aid effectiveness.

I. The definition of ODA.

One of the key topics regarding the new ODA definition is the inclusion of new financial instruments. Guarantees are currently not included in the ODA definition. Only when a guarantee is claimed the compensation paid can be reported as ODA. This is a great disincentive for DAC donors to use guarantees in their development activities. Some donor agencies are even prohibited to provide guarantees because their national laws only allow for the utilisation of financial instruments that can be reported as ODA. This is the main reason why (bilateral) development finance is currently dominated by grants and concessional loans.

This is in our view clearly not in the interest of developing countries, which face a huge gap in financing their needs in areas such as infrastructure, UN Millennium Development Goals (UN MDG) and climate change. Financial resources of governments in developing countries

(i.e. governments' own budgets) combined with multilateral and bilateral donor funds are not enough to bridge the financing gap. It is therefore of utmost importance to develop and use financial instruments that can be used to catalyse non-development finance / commercial finance (e.g. ECAs, commercial banks, capital market investors, private sector insurance / reinsurance markets). This should be a priority area for both governments in developing countries and the international donor community.
It is in our view also an essential theme within the policy agenda of aid efficiency and aid effectiveness, in particular since development aid over the past few years has increasingly become scarcer. There is a great challenge and responsibility for the donor community to find new innovative ways to do more with less and seek new forms of cooperation with other stakeholders in developing countries. Given the fact that guarantees are the best instrument to catalyse other sources of finance we advocate strongly an explicit recognition of these instruments in the ODA definition.

Regarding the technical details on how guarantees can catalyse other sources of finance and the benefits of these instruments for both developing countries and the development finance community it is referred to the Annexes I and II of this background paper.

Furthermore the OECD-DAC community could learn a lot from the longstanding and successful public private partnership between commercial banks and official Export Credit Agencies (ECAs). For many decades the ECAs have been very successful in using guarantees to catalyse commercial financing. If these government agencies can do it then the development finance community should be able to do it as well.

EIC would like to clarify that it is not the intention of our proposition to reduce or "water down" the development component of projects. We fully concur with the general prerequisites and requirements established by the OECD DAC for ODA and we agree that projects funded by development financiers should in any case and regardless of their financing structure bear the same requirements as development projects (e.g. IFC environmental and social standards, "Equator Principles"). This is a requirement that is currently already considered seriously by OECD ECAs.

II. Importance of improved cooperation between development finance and official Export Credit Agencies.

EIC notices that in the OECD both the development finance and the ECA communities operate more or less in "splendid isolation", whereas there are many opportunities for cooperation. Such cooperation could create substantial benefits for all stakeholders in particular for developing countries and the development finance - and ECA communities.

What are the most important considerations to really work on enhanced cooperation?

1. The economic crisis led to decreasing aid budgets of bilateral and multilateral donors, whereas insurance capacity of OECD ECAs remained unchanged and can be easily

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tapped for development purposes. The OECD ECAs provide much more support for medium and long-term (MLT) financing to developing countries than all leading multilateral development banks together;

2. Donors have to use their scarce development finance resources more efficiently and effectively (Paris Declaration);
3. Through (re-)insurance of the loan & guarantee exposure of Multilateral Development Banks (MDBs) and Bilateral Development Banks (BDBs) with ECAs the international donor community could catalyse ECA insurance capacity while the concept of untied can be maintained. In this way substantial amounts of capital of the development finance community can be freed up and used for other important development purposes;
4. Given the huge financing gap in areas such as infrastructure, UN MDGs and climate change this enhanced cooperation between development finance and ECAs is critical to bridge this gap;
5. Both ECAs and development finance agencies are owned & managed by governments, so it must be possible to build the required bridges between these two worlds.

We therefore strongly recommend OECD DAC and OECD ECG representatives to explore, develop and implement new strategies for enhanced cooperation.

III. Commercial viability test for untied aid.

In the OECD Arrangement for officially supported export credits clear rules have been successfully implemented to avoid that tied aid crowds out commercial / market based finance. One of the key concepts that has been developed is the so-called commercial viability test, which includes the following two key questions that tied aid donors need to consider, namely:

1. *Is the project “financially viable” (does it generate sufficient cash flow to repay market based loans)?*

   or

2. *Is it likely that market based finance will be sufficiently available to finance the project (read: are sufficient OECD ECAs on cover for the country / project involved?)*

We believe this commercial viability test should also be implemented for untied development aid that is not based upon market conditions. This includes concessional loans and other forms of subsidized loans to sovereign borrowers provided by multilateral and bilateral donors that are not market -/ risk based and benefit from a subsidy.

Projects that generate sufficient cash flow to repay market based loans and / or can indeed be financed on market terms and conditions do in our view not need a subsidy. It is better to use the scarce aid funds (subsidies) for important development projects that are not able to

generate sufficient direct project income to repay market based loans or cannot be financed on market based terms. These are typical public sector projects with important social and economic impacts and are critical to unlock the growth potential of countries. These public sector project can be found in areas such as:

1. Infrastructure (roads, railways, ports, water and sanitation)
2. Education
3. Health

For development donors the main arguments in favour of a "commercial viability test" for untied aid are:

1. To improve aid efficiency and aid effectiveness.
2. To avoid crowding out commercial finance.
3. To refine the complementary role of (semi) concessional development finance.

We strongly encourage the OECD DAC to explore how a commercial viability test could be developed for untied aid.

IV. The list of countries eligible for ODA.

Currently the ODA eligibility of countries is only based on assessment of the GNI per capita. If GNI per capita is higher than US$ 12,275 (2010 figure), than the country is not eligible for ODA. All countries with a GNI per capita below this threshold are eligible. The underlying assumption is that these countries need development finance. But is that really the case? Would it not be in the interest of aid effectiveness and aid efficiency to investigate whether the country is able to access the private financial market? This is currently not being done, as a result of which some governments that have adequate access to the private market do receive ODA. Does this make sense?

In this respect it is interesting that some ODA recipient countries have a dual role. On the one hand they receive ODA and on the other hand they provide aid to other developing countries[1]. It illustrates that the classical division between so-called developed and developing countries, solemnly based upon GNI per capita, is outdated. It is against this background we suggest to add a criterion for ODA eligibility, namely whether a country has adequate access to market based finance.

An interesting benchmark to assess whether countries have adequate access to the private market is the OECD classification for country risks. This is a classification for MLT risks and is used by OECD ECAs to determine the minimum premia for the risks they cover. If a country is classified in category 7 (which is the highest risk category) most OECD ECAs are likely off cover, which implies that the country has no or too limited access to MLT finance. These countries should therefore clearly be eligible for ODA and other forms of subsidised

[1] Examples are China, Brazil, Thailand and Turkey.

development finance.
A different assessment could be made for countries with an OECD ECA rating of 3 or better. In general these countries have adequate access to MLT market based finance. In annex III examples are given of these countries and the amounts of ODA they received and the IBRD / IDA loans outstanding on these countries.

EIC believes that the criterion “access to market based finance” for ODA eligibility of countries is a fair and objective criterion. It can also substantially enhance aid effectiveness and aid efficiency and assist in not crowding out private finance. We strongly encourage OECD DAC to discuss this suggestion and see how it can be incorporated into the ODA framework.

V. Complementary role of development finance.

Individual developing countries discuss on a regular basis with various multilateral and bilateral donors how development finance will be utilised. Within the multilateral aid community it is a common practice to describe the cooperation in a strategy paper, which covers in general a period of 3 – 5 years. The World Bank for example prepares a Country Assistance Strategy (CAS) paper for its lending activities provided by IBRD and IDA. The website of the World Bank describes the content and objective of these CASs as follows:

“Oriented toward results, the CAS is developed in consultation with country authorities, civil society organizations, development partners, and other stakeholders. The purpose of the CAS is to set out a selective program of Bank Group support linked to the country’s development strategy and based on the Bank Group’s comparative advantage in the context of other donor activities. CASs are designed to promote collaboration and coordination among development partners in a country”.

In summary, a CAS describes above all cooperation between IBRD / IDA and the government of a developing country and provides some insight on the (expected) financial contributions from other development donors. A strategy on how to mobilize private capital for development purposes or for cooperation with potential private financiers is clearly not a key theme in a CAS. As a consequence these CASs:

- Do not provide a clear overview about what the market is able to finance in a given country and what the unique complementary role of development finance should be.
- Lack clear targets on how private capital can be catalysed and how various products of IBRD and IDA (loans, grants and / or guarantees) can be used to attract private capital.
- Do not say anything about the pros and cons of the various products that are offered by IBRD/ IDA and they do not make visible the capital allocation of these different products.

In EIC’s view, this is a fundamental gap in the CAS. Unfortunately it is not unique to IBRD/ IDA. Similar gaps exist in strategy papers with other multilateral donors such as the EU and

other (regional) Development Banks. It all gives the impression as if the world of development finance ignores the roles and capabilities of the private financial sector. The international aid community – both on the donor and recipient side – seems to operate in its' own separate world. This "splendid isolation" is in our view not in the interest of developing countries and individual multilateral and bilateral donors involved. It is a breeding ground for criticism on aid.

For this reason it is recommended to put mobilisation of private capital and utilisation of development guarantees high on the strategic agenda of the international donor community. The donor community should together with aid recipient countries develop a clear strategy on how private capital can be mobilised to bridge the financing gap between financing needs of developing countries and the financing available from public sources (i.e. government own resources and development finance). The topic of private sector finance should be an integral part of the country strategy dialogue with developing countries. This is also essential to identify more precisely the unique complementary role of development finance. Development finance should not compete with commercial finance, but fill the gap where the market fails to operate.

VI. The aid activities of non-OECD countries.

During the past few years many non-OECD countries have become increasingly more active in providing development aid and official export credits to developing countries. Due to the fact that in these countries a distinction between the two – development finance and official export credits – does not exist they can easily blend the two to create an attractive financing package for developing countries. These non-OECD countries are not bound by OECD ECG and/or OECD DAC regulations. Often also the IMF and World Bank Debt Sustainability Framework (DSF) standards regarding a minimum concessionality are not adhered to. And last but not least the non-OECD financial offers are always tied aid packages.

The financing practices of these non-OECD countries clearly causes great disadvantages for the OECD business community with important implications for OECD societies. EIC is aware that this sensitive topic is already on the international agenda, but we see hardly any progress to come to any international understanding with key non-OECD countries.

We urge the OECD countries to increase the efforts to come to such an international understanding regarding both officially supported export credits and development aid. It is in the interest of both developing countries and OECD countries to improve the international framework on official export credits and development aid as soon as possible.

Berlin, 3- 4 March 2014

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Annex I Main benefits of development guarantees

Main benefits for developing countries:

I. Guarantees are key instruments to bridge the current financing gap in areas such as infrastructure, UN MDGs and climate change
II. Guarantees will assist in catalyzing substantial amounts of other – non-developmental – sources of finance: i.e. commercial finance from both public (ECAs) and private sources.
III. Guarantees will give developing countries access to other sources of finance at better terms & conditions than those available on the market (Bank market, Bond market, Official and Private (re-)Insurance markets).
    A. Longer credit periods (Up to 10 – 15 years)
    B. More favourable interest rates and lending conditions.
IV. Guarantees will assist in diversification of the funding base of Developing countries.
V. Guarantees will assist Developing countries in the transition from dependence on (Concessional / subsidized) development finance to market based finance.

Main benefits for the development finance community:

1. Guarantees will assist in catalysing substantial amounts of other – non developmental – sources of Finance (incl. private capital)
2. Guarantees will give Developing countries access to other sources of finance at better terms & conditions than those available on the market (Bank market, Bond market, Official and Private (re-)Insurance markets).
    A. Longer credit periods (Up to 10 – 15 year.
    B. More favourable interest rates and lending conditions.
3. Guarantees will assist in diversification of the funding base of Developing Countries.
4. Guarantees will assist Developing Countries in the transition from dependence on (Concessional / subsidized) development finance to market based finance.
5. Guarantees are key instruments to bridge the financing gap on infrastructure finance.
6. Guarantees will assist in mobilizing capital from the international insurance and re-insurance markets. Currently not or hardly used by MDBs & BDBs, except by certain specialized Multilateral Insurers (e.g. MIGA)
7. Guarantees can lower substantially the operational costs of MDBs & BDBs.
8. Guarantees can be effectively used for the development of the financial sector in developing countries.
9. Guarantees will allow Development Finance Community to build / enhance strategic alliances with commercial banks, bond investors, official ECAs and private (re-)insurers, both at an international level and locally in developing countries.
10. Guarantees make tailor-made risk sharing between commercial financiers and development financiers possible
11. Guarantees can assist in substantially increasing aid efficiency and aid effectiveness.

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Annex II How can guarantees can catalyse other sources of finance?

Introduction

It is generally recognised that budgets from governments in developing countries combined with development finance from both multilateral and bilateral donors are insufficient to finance the enormous needs of developing countries in areas such as infrastructure, UN MDGs and climate change. There is a huge financing gap, which can only be bridged by involving the private sector. This explains why catalysing private capital is an important theme in the development finance community.

The terms "mobilising", "leveraging" and "catalysing" private flows are frequently used in discussions on development finance, but no internationally agreed definitions of these terms exist. While many organisations publish data on their leveraging, their calculation methodologies vary substantially.

This issue is furthermore complicated by the fact that many development institutions tend to attribute the entire project investment to financial support provided by their own organisation, even though many other parties (e.g. equity investors, other development lenders, ECAs, commercial banks and governments) participate in the same project. This leads to substantial double counting (for example in case more than one guarantee provider is involved) and over-stated catalysing impacts. This is recognised by the OECD in its' recent survey on development guarantees[2] and explains why a common system for measuring the catalyzing impact of guarantees is currently discussed in the OECD..

I. Distinction between direct catalysing and indirect catalysing impact

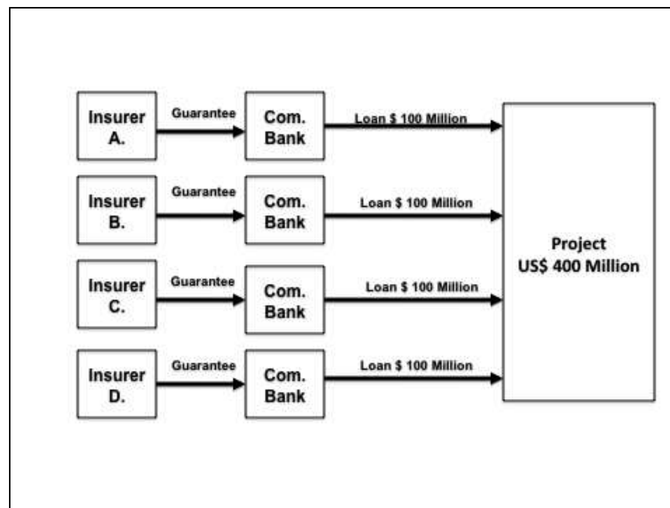
Guarantees can be used to catalyse commercial finance and non-commercial or development finance. Commercial finance can be capital provided by (1) private sector entities (i.e. private capital) or non-developmental public sector entities such as official ECAs/EXIM banks and official investment insurers (i.e. public non-developmental capital).

The capital catalysed through guarantees can be (1) equity investments or (2) debt investments. The focus in this annex is on how guarantees can theoretically catalyse debt investments from both private and public (risk) capital providers. Therefore we use the term "other sources of finance" instead of private capital. If we would focus only on private capital, the risk capital that is provided by official ECAs, EXIM banks and official investment insurers / financiers would remain out of the picture.

[2] The OECD survey can be found on the internet, see: http://www.oecd.org/dac/stats/guaranteesfordevelopment.htm

In measuring the catalysing impact of guarantees it is important to make a distinction between (1) direct catalysing and (2) indirect catalysing.

Parallel co-finance / co-insurance & indirect catalysing



Indirect catalysing concerns parallel co-financing or co-insurance whereby two or more independent loans or guarantees are provided to a project. In the example above there are four loans of each US$ 100 million to finance a project with a total value of US$ 400 million. All loans are (for simplicity reasons) 100% guaranteed by four different insurers, among which one development institution. Regarding the catalysing impact the development guarantor could “claim” that its guarantee for a US$ 100 million loan has catalysed a total investment of US$ 400 million. This implies a mobilization ratio of 1:4.

Obviously this would lead to double counting in case two or more development guarantors are involved. This should be avoided in particular since the development guarantor in the example is not actively involved in the three other guarantees (or loans). This is typical for parallel co-insurance (or parallel co-financing). It may be the case that the three other loans / guarantees have become available because of the development guarantee for the first loan, but the financing of US$ 300 million covered by three other guarantee providers cannot be directly attributed to the development guarantee for the first loan. It could, however, be argued that the development guarantee has indirectly catalysed US$ 300 million of additional finance / guarantees.

This explains why the distinction between direct and indirect catalysing is important. Direct catalysing requires an active role and involvement of a development institution. The guarantee structures where such an active role can be identified are the following:

1. Risk sharing with beneficiary of the guarantee.
2. Insurance of loan exposure.
3. Re-insurance of guarantee exposure
4. A/B co-insurance

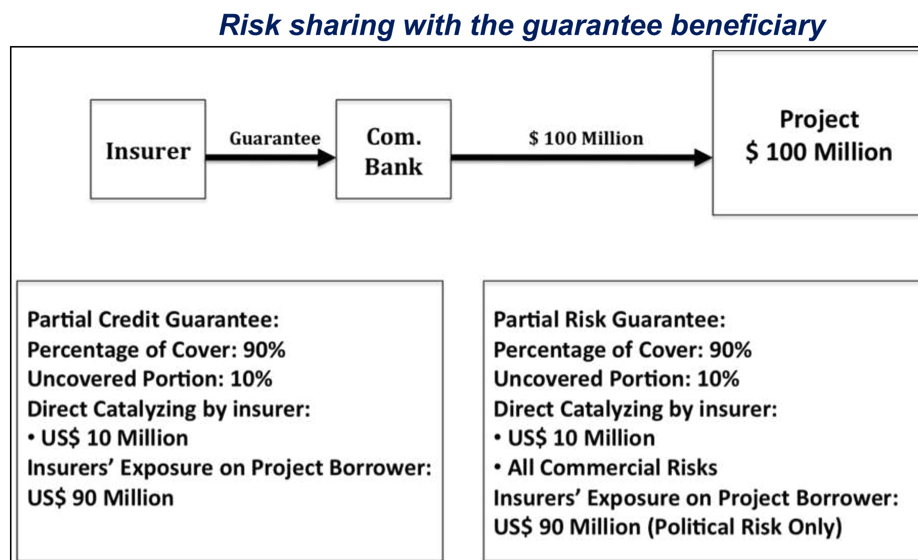
These structures are further explained below.

II.1 Risk sharing with the beneficiary of the guarantee

A guarantor can share risks with the guarantee beneficiary in three ways, namely by:

1. Applying a reduced percentage of cover. If the guarantor covers only 90% of each loss the insured lender will take 10% of each loss. In this way the guarantor catalyses 10% of other sources of finance.
2. Providing the guarantee to only a part of the repayments of a loan and not all of them. If a loan of US$ 100 million is to be repaid in 20 semi-annual repayments of each US$ 5 million and the guarantor covers only the last 5 years of the credit (in total US$ 50 million) the lender takes the repayment exposure during the first 5 years on its' own account. In this way the guarantor catalyses 50% of other sources of capital.
3. Covering only certain payment risks.
   In a private sector project whereby the guarantor covers only certain political risks (e.g. transfer risk, inconvertibility risk, expropriation and (civil) war) the commercial risks are borne by the insured lender. In such a case the guarantor catalyses other sources of capital to take/cover commercial risks. It is a challenge to quantify this catalysing effect of this specific form of risk sharing.

Risk sharing with the guarantee beneficiary



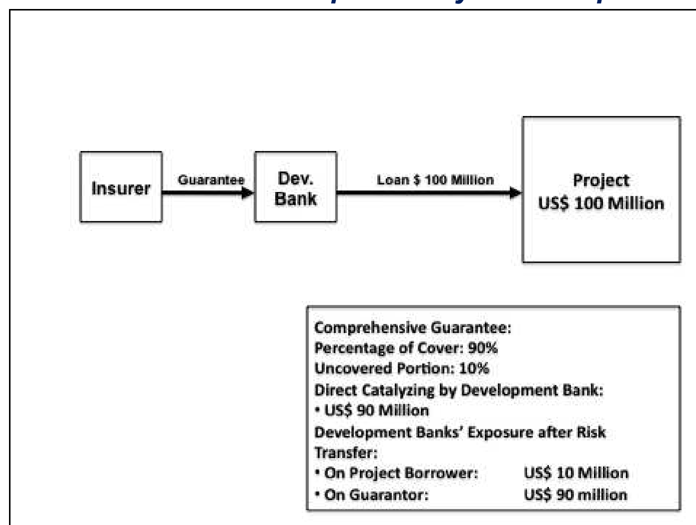
Within the multilateral development finance community the risk sharing arrangements mentioned under 1 and 2 are known as "Partial Credit Guarantees (PCG)" and those under 3 are called "Partial Risk Guarantees (PRG)".

II.2. Insurance of loan exposure

A development bank has – like commercial banks – the option to take the risks regarding its loan exposure on its own balance sheet or it can buy insurance from various guarantee providers to protect itself against payment defaults. Insurance of loan exposure requires an active risk transfer role of the development institution. In the example below it is assumed that a development bank provides a loan of US$ 100 million to a project. This loan is covered against all risks for 90% (i.e. comprehensive cover), which implies that the development bank has transferred US$ 90 million of the risk from the borrower to the insurer. An amount of US$ 10 million borrower risk remains on the balance sheet of the development bank. In addition the development bank runs an insurance counterparty risk of US$ 90 million on the insurer. In this example the development bank has catalysed 90% of other sources of finance.

Thanks to the insurance the risk profile of the loan has improved substantially and the insured loan requires likely much less (risk) capital for the development bank. Capital that is freed up can be used for other important developmental projects.

Insurance of loan exposure by a development bank



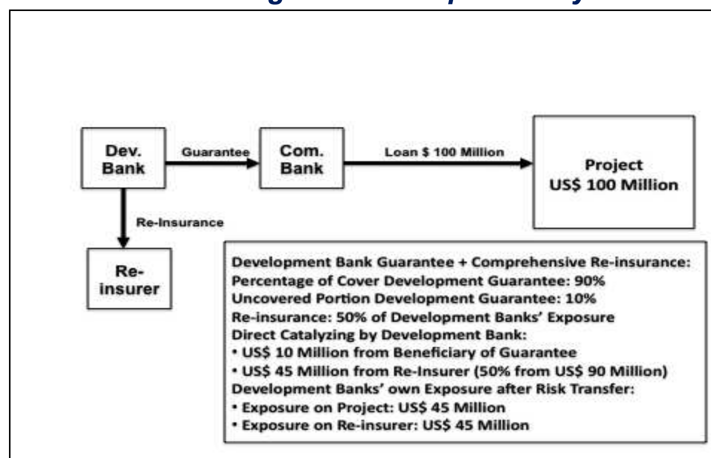
II.3. Reinsurance of guarantee exposure

A development bank that has provided a development guarantee for a certain project can seek reinsurance for its guarantee exposure. In the example below there is a commercial bank that provides a US$ 100 million loan to a project. This loan is for 90% guaranteed by a development bank, which is equal to an amount of US$ 90 million. Of this US$ 90 million the development bank obtained reinsurance for US$ 45 million (50% of the guaranteed exposure). The total direct catalysing impact of the guarantee activities of the development bank is equal to an amount of US$ 55 million (the sum of the uninsured portion of the

guarantee and the reinsured amount). In this transaction the development bank has directly catalysed 55% of other sources of finance.

Thanks to the reinsurance the risk profile of the guarantee has improved substantially and the guarantee requires likely much less (risk) capital for the development bank. Capital that is freed up can be used for other important developmental projects.

Reinsurance of guarantee exposure by a development bank



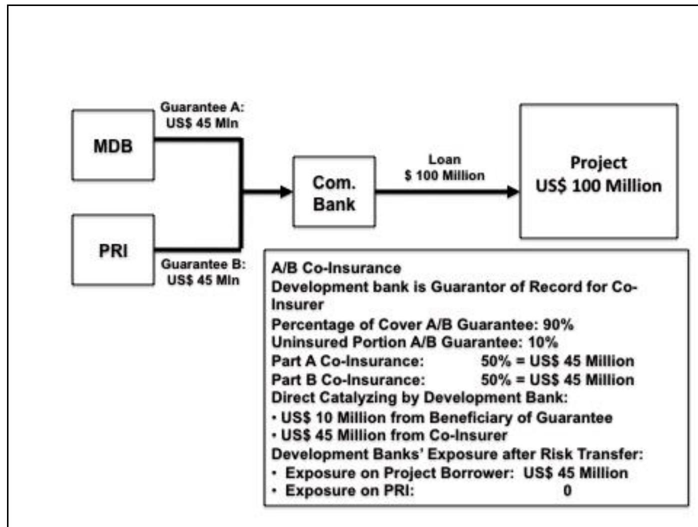
II.4. A/B co-insurance

A/B co-insurance is more or less similar to A/B co-financing. There is only one guarantee document, but under this guarantee there are two or more (co-)insurers. This is where the structure differs from parallel co-insurance. In case of parallel co-insurance there are two or more loans and each loan is insured / guaranteed by one insurance policy / guarantee.

In the A/B co-insurance structure the A portion of the guarantee is made available by a development bank and the B part of the guarantee is provided by one or more other guarantee providers, which could be private insurance companies or official ECAs. The development bank acts as "guarantor of record" for its own part of the guarantee (part A) and for the parts of the other (co-)insurers (part B). In this way the guarantor(s) of the B part will benefit from the preferred creditor status of the development bank. In the example below there is a US$ 100 million loan that is A/B co-insured by a development bank. The guarantee covers 90% of the risk (US$ 90 million) of which US$ 45 million is covered by a development bank (part A) and US$ 45 million by another insurer (part B), which has been arranged by the development bank.

The total direct catalysing impact of the guarantee activities of the development bank is an amount of US$ 55 million (the sum of the uninsured portion of the guarantee and the co-insured amount), which is equal to 55% of the total project costs.

A/B Co-insurance



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Annex III Examples of ODA recipient countries with access to market based finance

Examples of ODA recipient countries with access to market based finance

	OECD	S&P Long Term	Net ODA	IBRD/IDA Loans
Country	**ECA Rating (a)**	**FC Rating (b)**	**in Mln. US$ ©**	**in Mln. US$ (d)**
Botswana	3	A+	157	64
Brazil	3	AA-	664	9,074
Chili	2	A-	198	127
China	2	BBB	648	20,538
Costa Rica	3	BBB-	96	585
India	3	BBB-	2,807	38,374
Mauritius	3	n.a.	125	250
Mexico	3	BBB	473	13,625
Morocco	3	BBB-	994	2,901
Namibia	3	n.a.	259	0
Panama	3	BBB-	129	405
Peru	3	BBB	-254	2,650
South Africa	3	BBB+	1,032	781
Thailand	3	BBB+	-11	63
Tunesia	3	BBB-	551	1,819
Uruguay	3	BB+	49	1,139
Total			**7,917**	**92,395**

(a) This is the OECD ECA rating of February 2012
(b) This is the S&P long term Foreign Currency rating of February 2012
(c) This is net bilateral ODA provided in 2010
(d) These are the (sovereign) loans outstanding of IBRD / IDA in March 2012.