FINANCING INFRASTRUCTURE

The (non) concessionality of concessional loans

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10 September 2020

VERITÉ RESEARCH
Strategic Analysis for Asia

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Foreign Loans 2005-2019

An Overview

81% of the value of foreign loans taken was for Infrastructure

The boom in infrastructure financing post-2009 slowed down post 2014

Value of loans taken during 2010-2014 was 109% higher than in 2005-2009

Value of loans taken during 2015-2019 was 26% lower than in 2010-2014

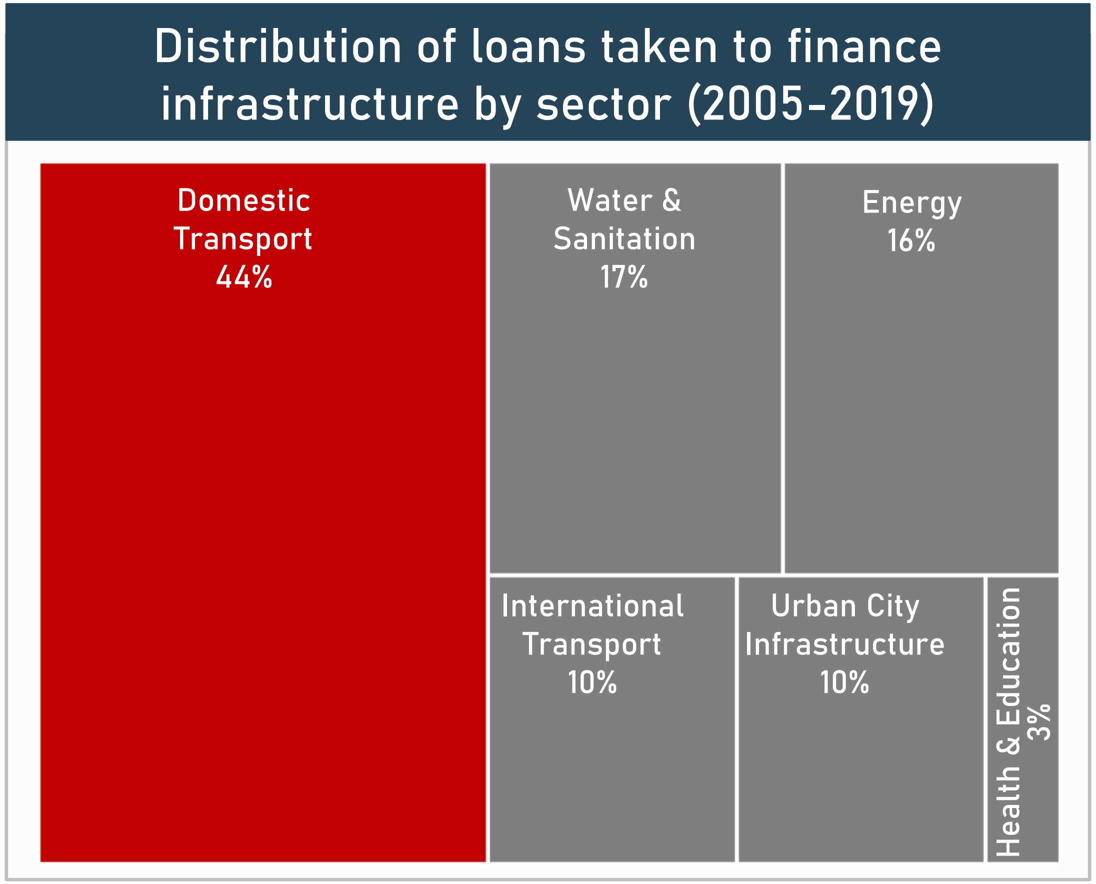
Value of Loans taken from abroad*

Period	Value (USD million)		Share (%)	
	Infrastructure	Non-infrastructure	Infrastructure	Non-infrastructure
2005-2009	5,936	1,308	82	18
2010-2014	12,394	1,945	86	14
2015-2019	9,174	3,268	74	26
Total	27,504	6,521	81	19

*This includes loans taken by SOEs for Infrastructure loans (Guarantees by the Central Government). However not for the non infrastructure loans

Source: Department of External Resources and the Ministry of Finance of Sri Lanka

44% of the loans taken for infrastructure was for Domestic Transport Infrastructure



Sector	Subcategories
Domestic Transport	Roads, bridges, highways and railways
Water and Sanitation	Construction of water supply & sanitation and wastewater management facilities
Energy	Powerplants and transmission related projects
International Transport	Seaports and airports
Health and Education	Physical construction of health and education facilities
Urban-City Infrastructure	These are projects which encompasses several of the above-mentioned sectors
Environment	Solid waste management

Source: Department of External Resources and the Ministry of Finance of Sri Lanka

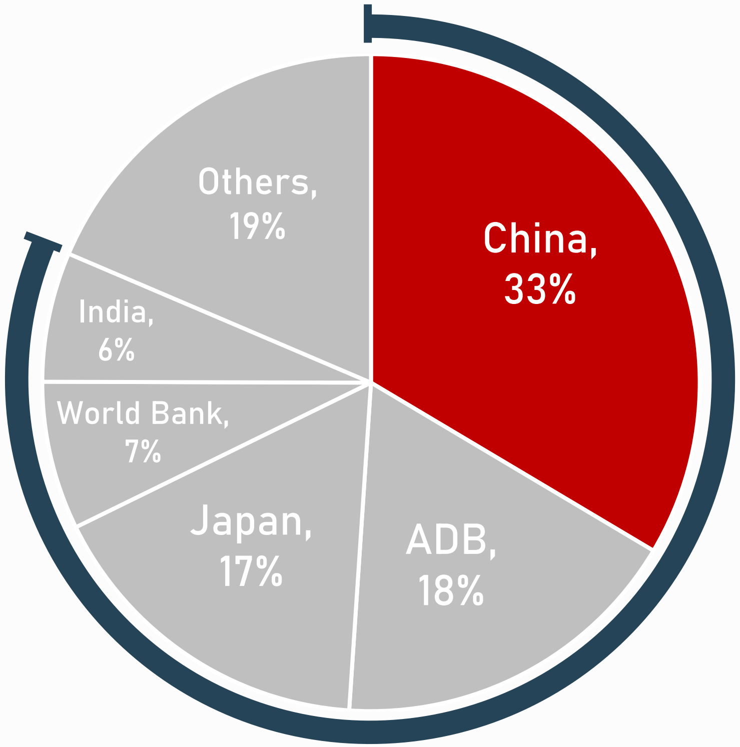
China was the largest lender for infrastructure accounting for 33% of total loans taken

Infrastructure financing by lender (2005-2019)

Total Value : USD 27.5 Billion

Total Number of Loans : 313

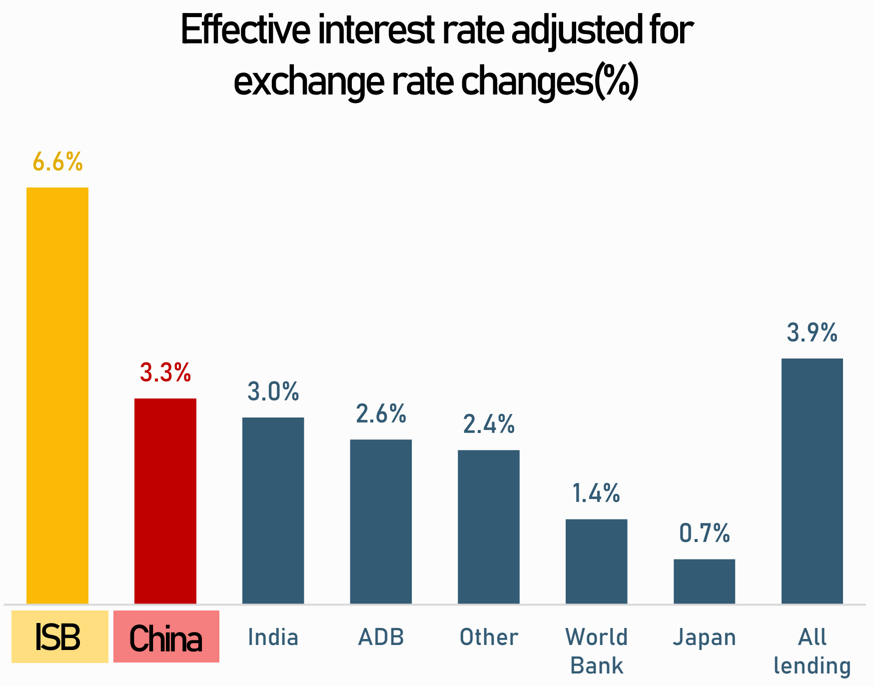
Share of top five lenders : 81% ▶

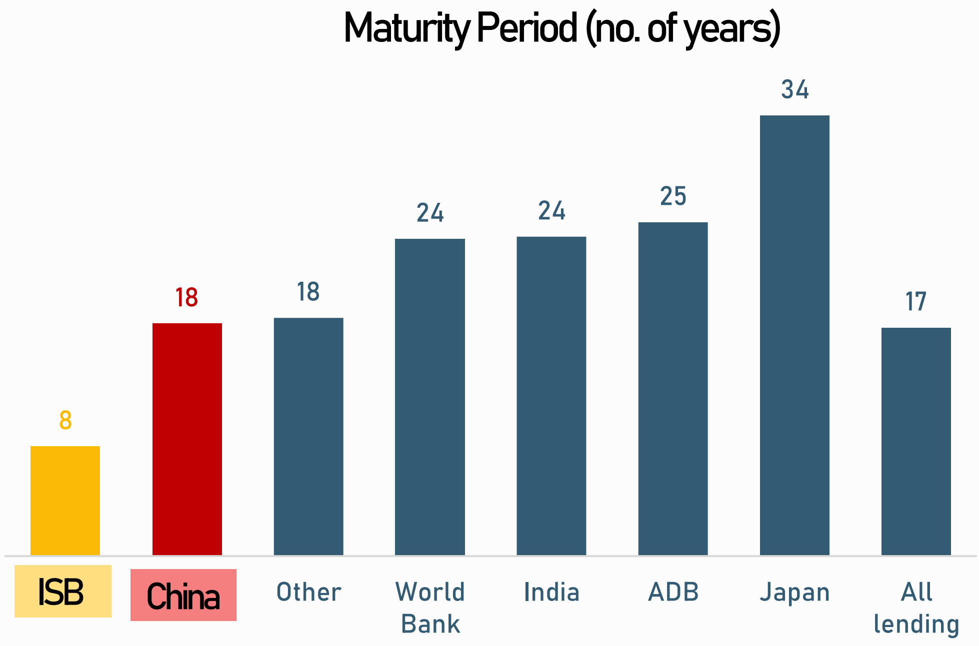


Source: Department of External Resources and the Ministry of Finance of Sri Lanka

Loans from China were cheaper than ISBs and had longer maturity periods

Major sources of foreign funding (2005-2019)





Source: Department of External Resources, the Ministry of Finance of Sri Lanka and *Central Bank of Sri Lanka*

Measuring loan concessionality

Methodology and Key Findings

Analysing the concessionality of foreign loans

Verité Research analysed

- 50 high value foreign loans taken for infrastructure financing during 2005-2018
- Total value of the 50 Loans: USD 13 bn
  53% of all infrastructure loans: 2005-2018
- 15 multilateral loans and 35 bilateral loans
  - 46 loans of the central government: USD 11,972 million
  - 4 loans to the state-owned enterprises: USD 1,096 million

Analysing the concessionality of foreign loans

Methodology ▾

- Measure level of concession using grant element of the loan
- Measure the tied element of the loan
- Using the GE and TE, measure the non-concessional threshold of the loan

1. Grant element of the loan ▾

The difference between the nominal loan value and the present value of the loan repayments anticipated under the terms of the loan.

The grant element for the loans have been calculated as follows:

$$\mathbf{GE} = \frac{\mathbf{NV} - \mathbf{PV}}{\mathbf{NV}}$$

GE – Grant element of the loan
NV – Nominal value of the loan
PV – Present value of the loan

Analysing the concessionality of foreign loans

Methodology ▾

- Measure level of concession using grant element of the loan
- Measure the tied element of the loan
- Using the GE and TE, measure the non-concessional threshold of the loan

2. Defining concessionality using grant element – International benchmarks ▾

	Discount rate	Minimum grant element required to classify loan as concessional
IMF	5%	35%
OECD Export Credits	Differentiated Discount Rate*	35%
Verité Research	6.5% (average rate of ISBs)	35%

*Differentiated discount rate is applied based on the Commercial Interest Reference Rates (CIRRs) (the official lending rates of Export Credit Agencies) and a margin specific to the repayment term of the specific loan

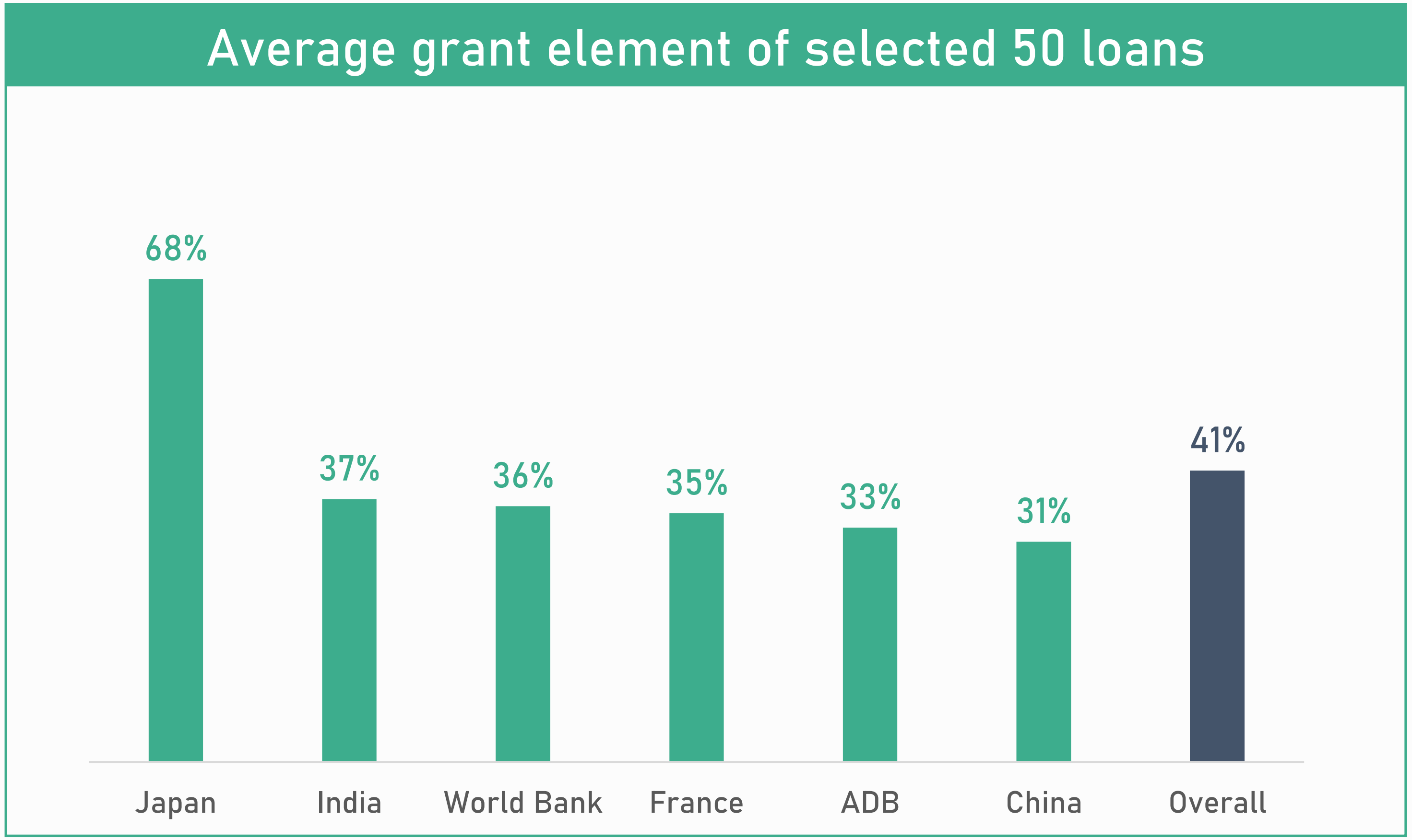
Key findings:

1) Bilateral/multilateral loans tend to be more concessional when compared to ISBs

Of the 50 loans,

33 loans had a grant element of above 35%,

these 33 loans account for 72% of the value of the 50 loans analysed



Source: Calculated using information provided by the External Resources Department of the Ministry of Finance and the responses received to requests for information filed under the Right to Information Act No. 12 of 2016 with the respective implementing agencies of the projects in the Government.

Erosion of Concessionality

Methodology and Key Findings

Grant element fails to capture "hidden costs" that result from the "tied element" of the loan

Methodology ▼

- Measure level of concession using grant element of the loan
- Measure the tied element of the Loan
- Using the GE and TE, measure the non-concessional threshold of the loan

1. Tied element of the loan

The tied element of the loan refers to the portion of the loan that is, in effect, (in law or in fact) tied to the procurement of goods/services from contractors connected to the lender.

Grant element fails to capture "hidden costs"

that result from the "tied element" of the loan

Methodology ▼

- Measure level of concession using grant Element of the Loan
- Measure the tied element of the loan
- Using the GE and TE, measure the non-concessional threshold of the loan

Tied element prevent competitive bidding

↓

Increases the risk of cost escalations

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If cost escalation > grant element

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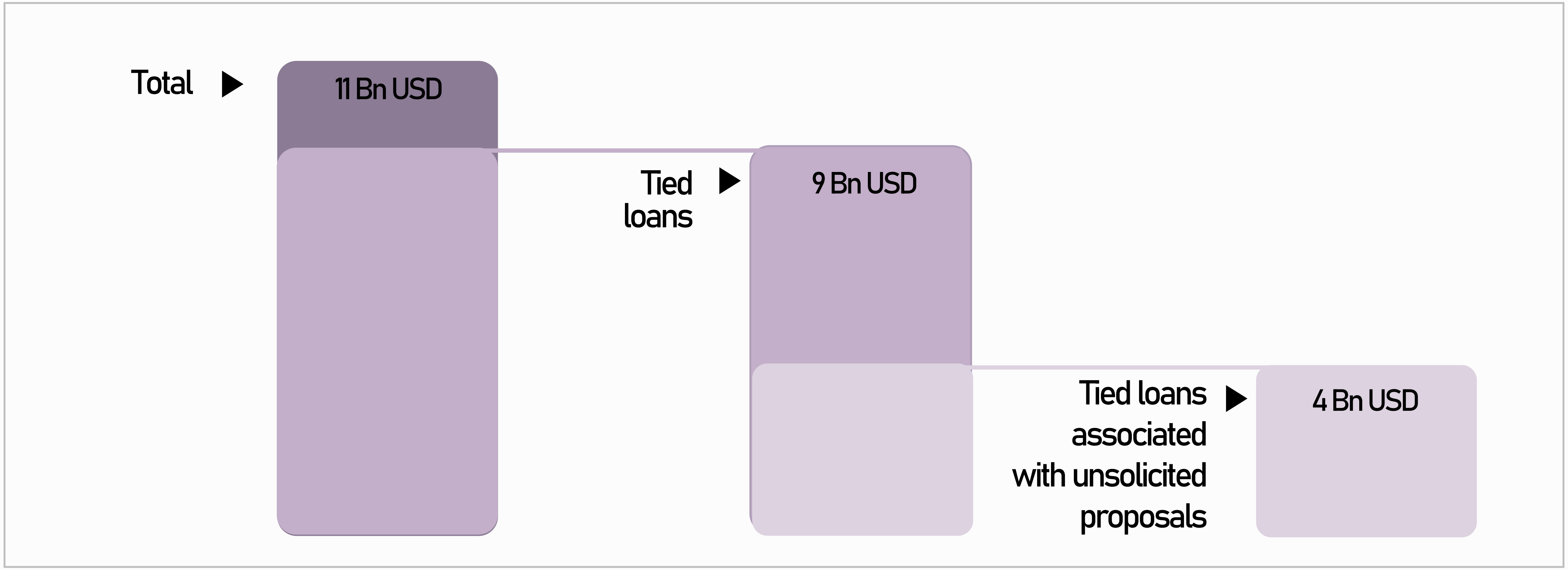
Loan is no longer concessional but adverse

Key findings:

2) Benefits of favourable financial terms offered by bilateral loans can be significantly eroded by unfavourable procurement methods



Source: Calculated using information provided by the External Resources Department of the Ministry of Finance and the responses received to requests for information filed under the Right to Information Act No. 12 of 2016 with the respective implementing agencies of the projects in the Government.

Key findings:

2) Benefits of favourable financial terms offered by bilateral loans can be significantly eroded by unfavourable procurement methods (Cont.)

Lender	Number of tied loans			
	Total analysed	Restricted bidding*	Unsolicited proposals**	Contractor pre-selected***
China	18	1	12	5
India	3	2	-	1
Japan	6	6	-	
CIB (France)	1	-	1	
Total	28	9	13	6

*entire or potion of the loan value is tied to procurement from a contractor of the lender's country.

**a proposal submitted by a firm on its own initiative, not as a response to a request for a proposal by the government

*** contractor from the country of the lender, selected prior to signing of the loan agreement.

Source: Calculated using information provided by the External Resources Department of the Ministry of Finance and the responses received to requests for information filed under the Right to Information Act No. 12 of 2016 with the respective implementing agencies of the projects in the Government.

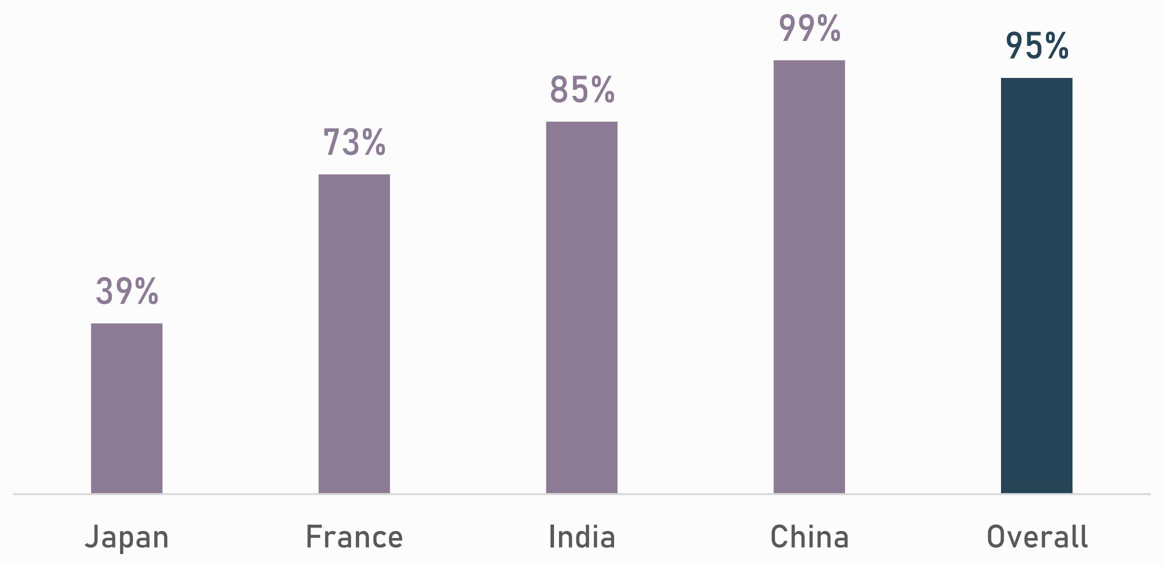
Key findings:

2) Benefits of favourable financial terms offered by bilateral loans can be significantly eroded by unfavourable procurement methods (Cont.)

The tied element could be calculated for 22 loans:

- 14 loans had a tied element of 100%
- 6 loans had a tied element between 60%-100%
- 2 loans had a tied element of a minimum of 30%

Average tied element by lender
(22 tied loans)



Source: Calculated using information provided by the External Resources Department of the Ministry of Finance and the responses received to requests for information filed under the Right to Information Act No. 12 of 2016 with the respective implementing agencies of the projects in the Government.

Analysing the non concessionality of foreign loans

Methodology ▾

- Measure level of concession using grant Element of the Loan
- Measure the Tied Element of the Loan
- Using the GE and TE, measure the non-concessional threshold of the loan

1. Non-concessional threshold ▾

The point at which the cost escalation on the tied element equals the grant element of the loan

The non-concessional threshold for the loans have been calculated as follows:

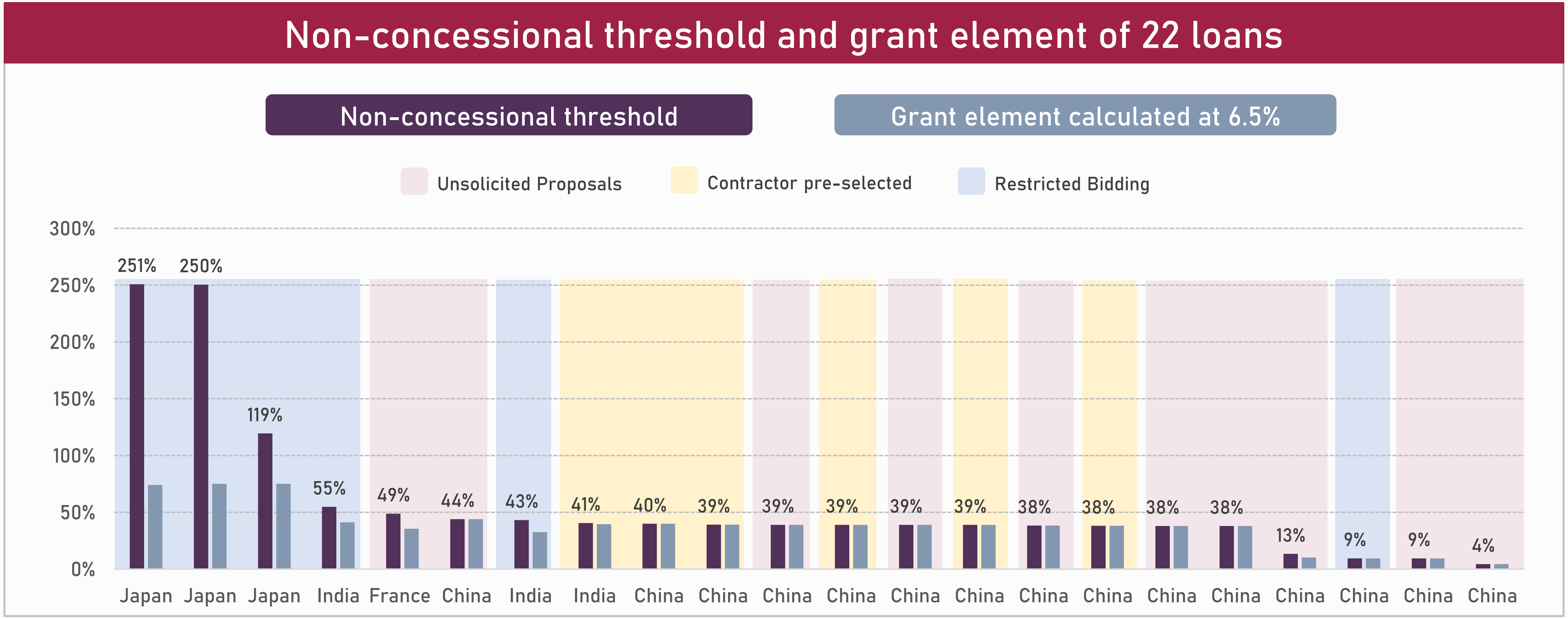
$$\mathbf{NCT} = \frac{\mathbf{GE}}{\mathbf{TE}}$$

NCT - Non-concessional threshold of the loan
GE – Grant element of the loan
TE – Tied element of the loan

Key findings:

3) Loans from China are more at risk of being non-concessional

The non-concessional threshold: the level of cost escalation on the tied element at which the grant element of the loan would be negated. When the cost escalation exceeds that threshold, the loan terms become inferior to borrowing on financial markets



Source: Calculated using information provided by the External Resources Department of the Ministry of Finance and the responses received to requests for information filed under the Right to Information Act No. 12 of 2016 with the respective implementing agencies of the projects in the Government.

For projects initiated through unsolicited proposals, the risk and extent of costs escalation can be especially high

Unsolicited proposals ▼

A proposal made by a private party to undertake a public-private partnership (PPP) project, submitted at the initiative of the firm, rather than in response to a request from the government.' (World Bank, 2019)

Of the 28 loans with a tied element, 13 (worth USD 3,504 million) were implemented through unsolicited proposals:

- 12 were funded by loans from China.
- 1 from Calyon Credit Agricole CIB of France.

- The procurement process for projects originating as unsolicited proposals can be particularly non-competitive.
- These projects often face widespread allegation of corruption and fraud (PPIAF, 2014, p.6).
- The regulatory regime governing USPs in Sri Lanka is particularly weak.
- A diagnostic note prepared by the World Bank states that the mechanisms and procedures for handling unsolicited proposals need to be clarified and strengthened to ensure more effective adherence to the principles of competitive tendering and value for money (Rajapaksa , 2017, p. 2).

Implications for policy makers

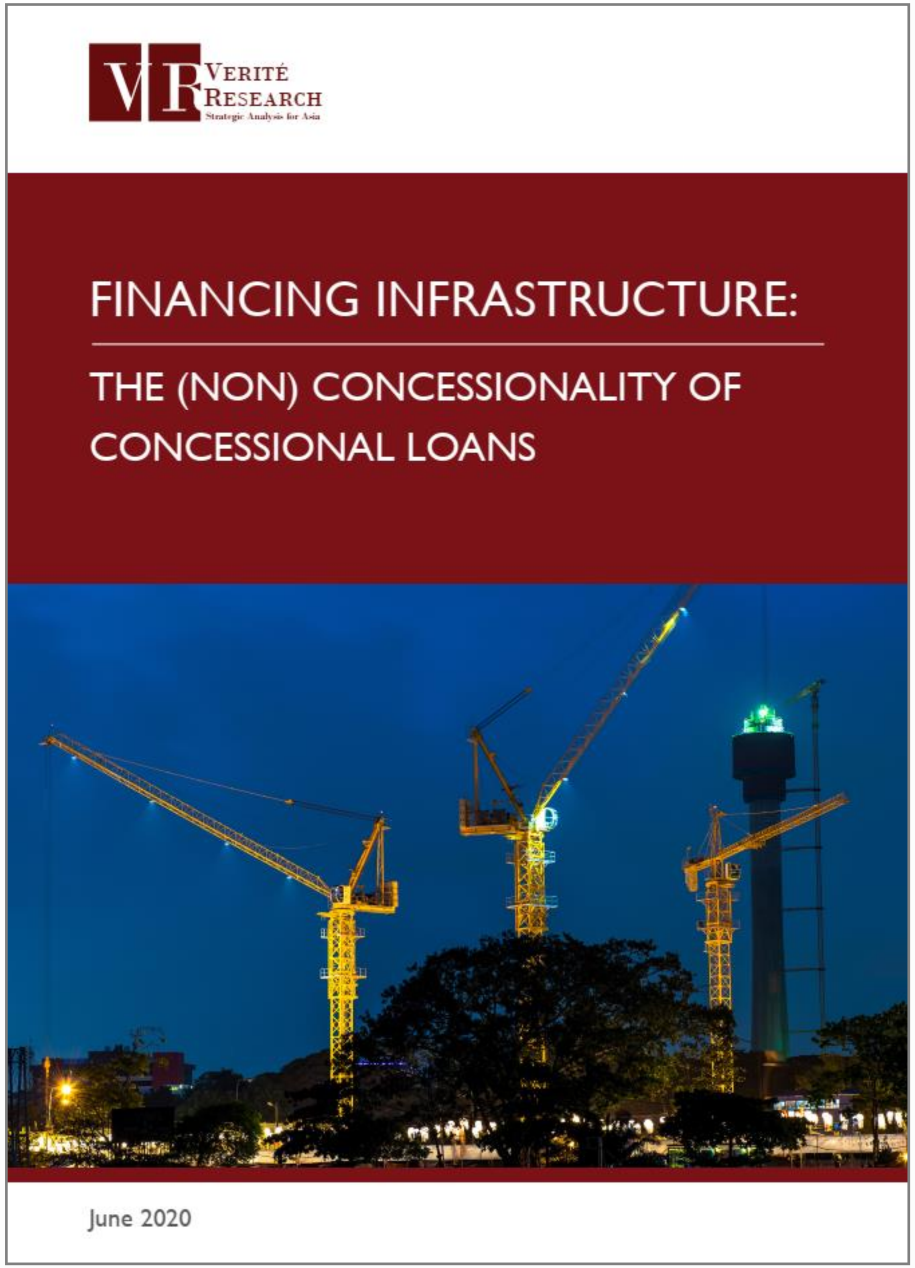
- Recognise that loan concessionality can be reversed through procurement terms
- Require analysis of cost impact from tied procurement conditions
- Strengthen regulation to reduce unsolicited procurement proposals
- Withdraw existing discretion for 'secret' accession to adverse loan terms

Financing Infrastructure:

The (non) Concessionality of Concessional Loans

The complete report can be accessed through:

www.veriteresearch.org/publication



Thank You

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