FINANCING INFRASTRUCTURE
The (non) concessionality of concessional loans

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10 September 2020
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An overview of foreign loans (2005-2019)

Concessionality of foreign loans

Erosion of Concessionality
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

<table>
<thead>
<tr>
<th>Period</th>
<th>Value (USD million)</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Infrastructure</td>
<td>Non-infrastructure</td>
</tr>
<tr>
<td>2005–2009</td>
<td>5,936</td>
<td>1,308</td>
</tr>
<tr>
<td>2010–2014</td>
<td>12,394</td>
<td>1,945</td>
</tr>
<tr>
<td>2015–2019</td>
<td>9,174</td>
<td>3,268</td>
</tr>
<tr>
<td>Total</td>
<td>27,504</td>
<td>6,521</td>
</tr>
</tbody>
</table>

*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

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

### Distribution of loans taken to finance infrastructure by sector (2005-2019)

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

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)

- China, 33%
- ADB, 18%
- Japan, 17%
- World Bank, 7%
- India, 6%
- Others, 19%

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)

**Effective interest rate adjusted for exchange rate changes (%)**

- ISB: 6.6%
- China: 3.3%
- India: 3.0%
- ADB: 2.6%
- Other: 2.4%
- World Bank: 1.4%
- Japan: 0.7%
- All lending: 3.9%

**Maturity Period (no. of years)**

- ISB: 8
- China: 18
- Other: 24
- World Bank: 24
- India: 25
- ADB: 34
- Japan: 17
- All lending: 17

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:

\[
GE = \frac{NV - PV}{NV}
\]

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 ▼

<table>
<thead>
<tr>
<th></th>
<th>Discount rate</th>
<th>Minimum grant element required to classify loan as concessional</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF</td>
<td>5%</td>
<td>35%</td>
</tr>
<tr>
<td>OECD Export Credits</td>
<td>Differentiated Discount Rate*</td>
<td>35%</td>
</tr>
<tr>
<td>Verité Research</td>
<td>6.5% (average rate of ISBs)</td>
<td>35%</td>
</tr>
</tbody>
</table>

*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

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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

Average grant element of selected 50 loans

<table>
<thead>
<tr>
<th>Country</th>
<th>Average Grant Element</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>68%</td>
</tr>
<tr>
<td>India</td>
<td>37%</td>
</tr>
<tr>
<td>World Bank</td>
<td>36%</td>
</tr>
<tr>
<td>France</td>
<td>35%</td>
</tr>
<tr>
<td>ADB</td>
<td>33%</td>
</tr>
<tr>
<td>China</td>
<td>31%</td>
</tr>
<tr>
<td>Overall</td>
<td>41%</td>
</tr>
</tbody>
</table>

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

If cost escalation > grant element

Loan is no longer concessional but adverse
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.
2) Benefits of favourable financial terms offered by bilateral loans can be significantly eroded by unfavourable procurement methods (Cont.)

Key findings:

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.

<table>
<thead>
<tr>
<th>Lender</th>
<th>Total analysed</th>
<th>Restricted bidding*</th>
<th>Unsolicited proposals**</th>
<th>Contractor pre-selected***</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>18</td>
<td>1</td>
<td>12</td>
<td>5</td>
</tr>
<tr>
<td>India</td>
<td>3</td>
<td>2</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>6</td>
<td>6</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CIB (France)</td>
<td>1</td>
<td>-</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>28</td>
<td>9</td>
<td>13</td>
<td>6</td>
</tr>
</tbody>
</table>

*Entire or portion 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.
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:

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

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.

Non-concessional threshold and grant element of 22 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.

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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:

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