

Concessional Credit, Latent Risks, and Policy Transmission

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- This is the final article of *'The Great Development Finance Write-Off'* series.
- Central banks and regulators confront masked concessionality in bank lending that undermines policy pass-through, distorts capital requirements, and weakens the international financial architecture.
- When grant-equivalents go untagged, supervisory data erodes, risk-weighted assets (RWA) are systematically misrepresented, stress tests neglect critical tail risks, and collateral valuations ignore actual credit cost—compromising financial stability and macroprudential policy.
- Understand why incorporating concessionality and donation metrics into credit registries, RWA methodologies, stress-testing frameworks, and collateral-valuation rules is essential to reclaim accurate risk assessments and safeguard effective monetary policy transmission.

In emerging-market and developing economies (EMDEs), central banks are tasked with preserving price stability and systemic resilience, overseeing payment and settlement infrastructures, and ensuring effective monetary policy transmission through banking systems marked by volatile cross-border flows and shallow domestic intermediation. Their mandates becomes even more challenging when banking and non-banking financial institutions intermediate concessional financial instruments by development finance institutions (DFIs) and multilateral development banks (MDBs) without accurately pricing or transparently reporting each embedded concessionality element.

Policymakers should clearly distinguish between bankability and viability. The former is defined as being able to secure private-sector financing, while the latter is defined as having positive net present value (NPV). In Blended Finance structures, concessionality may be allowed to enhance private sector returns, but this transfer of value is justified only when NPV is positive. Conflating bankability with viability and ignoring embedded concessionality elements undermines underwriting discipline: sovereigns, DFIs, MDBs with non-sovereign guaranteed operations (NSGOs), and private-sector institutions may end up financing projects that destroy economic value and incur losses even on concessional terms.

When banking and non-banking financial institutions intermediate DFI and MDB loans, an activity termed DFI and MDB “indirect lending,” another issue arises: these loans are often commingled with the financial institutions' other liabilities, masking thematic rates, such as green, infrastructure, and SME lending. This not only camouflages concessionality but can also block the transmission of policy priorities. Because sovereign shareholders use DFIs and MDBs as policy tools, the thematic rates of DFIs and MDBs should influence allocation decisions. For example, suppose that an MDB, having been mandated by its sovereign

shareholders to promote women's economic empowerment, offers a loan under the 2X Challenge theme to a bank at its lowest rate, but the bank does not inform its SME clients that the 2X Challenge rate is lower than the SME rate. In that case, SMEs have no incentive to adapt their operations and structures—ownership, leadership, employment, supply chains, and products and services—to meet the 2X Challenge criteria.

Nick Kolev's *"Pricing Development Assets in Non-Sovereign Guaranteed Operations"* highlights yet another issue: because NSGOs are restricted by the principle of Additionality, commercial and development markets are segmented. In this framework, concessionality—defined as the difference between the commercial market price and the traded price—differs from donation—the difference between the development market price and the traded price. When the traded price equals the commercial market price, no concessionality element exists, but a donation element may still be present. The existence of such donation elements implies that DFIs and MDBs can generate development impact without concessionality. Specifically, this may be the case when DFIs and MDBs offer—on commercial market terms, as required by the principle of Non-Distortion—loans with longer terms than the loans offered by banking and non-banking financial institutions. Similarly, this may be the case when DFIs and MDBs help borrowers, on commercial market terms and whenever appropriate, convert their foreign currency loans to local currency loans. Therefore, scarce DFI and MDB donation capacity can be deployed without concessionality to strengthen systemic stability.

Kolev's model demonstrates that concessionality is not a reliable measure of development impact. In line with the logic behind government aid, to which official development assistance (ODA) determined by the Development Assistance Committee is closely related, development impact should be measured as a function of the amount of aid, or donation, which includes technical assistance to the private sector and advisory services to the public sector. For central banks in EMDEs, this implies a need for both theoretical and practical support from DFIs and MDBs to develop markets, processes, and systems—first through the establishment of frameworks, and then via pilot programs. Such support requires no special funding resources and can be provided from ordinary capital resources. DFI and MDB assistance that fosters macroeconomic stability, improves legal predictability, and strengthens market infrastructure is especially critical in today's context of unsustainable indebtedness, as EMDEs seek to upgrade creditworthiness, attract foreign investment, and advance regional integration urgently.

Extending Kolev's concept of donation to ODA accounting would introduce both clarity and simplicity. Measuring donation elements as price differences is consistent and rational, and it avoids the imaginary complexity often ascribed to non-debt instruments. This approach would particularly benefit equity investments, and foreign direct investment (FDI) is equity by definition. FDI, which is accompanied by the transfer of technological know-how and managerial expertise, plays a crucial role in economic growth. By encouraging private companies to list publicly, FDI can deepen market liquidity and improve price discovery. In

turn, as equity markets mature in sophistication and scale, they can attract further FDI by alleviating concerns over minority-equity positions.

Central banks can benefit from a clear understanding of concessionality and donation—and of the distinction between them—when designing prudential rules. Such rules should require banks to do the following:

- (i) Tag each DFI/MDB concessionality element and maintain equivalent tags for purely commercial loans with similar tenors, covenants, and risk profiles;
- (ii) For every tagged exposure, reconstruct and report a market-equivalent cash-flow profile alongside the contractual profile (e.g., a loan of 100 at 5% concessional is shown as 100 at the prevailing 10% market rate, with the 5% periodic shortfall presented as an explicit concessionality schedule), enabling supervisors to decide how—if at all—to incorporate the market-equivalent view into exposure limits and capital metrics;
- (iii) Ensure that internal systems can generate, from the same tags, both (a) a market equivalent risk view—risk weights, loss-given-default assumptions, liquidity haircuts, and reserve requirements calibrated to the full market exposure (including any imputed cost of intermediation)—and (b) the contractual view with the donation shown separately, enabling supervisors to specify the prudential treatment.

Credit registries and stress-testing templates should separate market exposures from concessionality elements, allowing macroprudential teams to measure system-wide credit and market risks without the noise of concessionality. When a financial institution uses intermediated DFI and MDB loans as collateral at a central bank's lending facility (e.g., the discount window), valuations should reference market prices for the underlying loans and deduct any concessionality elements passed through to end-beneficiaries. This prevents inadvertent monetization of concessionality elements and preserves the integrity of the collateral framework.

The measures proposed fall squarely within existing supervisory mandates: without altering budgetary decisions, they ensure that monetary and supervisory authorities classify and treat concessional flows transparently. Implementing the measures—via revised reporting forms, concessionality element tags in loan ledgers, and joint working groups with development institutions on data standards—turns concessional opacity into actionable public policy information. For EMDEs, implementation levels the playing field: authorities can uphold international standards without assuming unanticipated fiscal risks, and development impact can be preserved rather than diluted by monetary operations. Central banks can deploy this approach immediately with existing tools. The alternative is continued ambiguity—with political, diplomatic, and humanitarian costs when concessionality amplifies, instead of mitigates, shocks.

Definitions:

1. *Non-sovereign guaranteed operation* (NSGO): An investment made by an MDB without a sovereign guarantee. By definition, all DFI operations are NSGOs.
2. *Concessionality*: The difference between the commercial market price and the actual traded price of an instrument, e.g., the subsidy embedded in loan terms.
3. *Donation*: The difference between the development market price and the actual traded price, i.e., the public-sector “grant equivalent” component.
4. *Additionality*: The principle that, in NSGOs, DFIs and MDBs do not undertake any financing for which sufficient private capital can be obtained on reasonable terms.
5. *Non-Distortion*: The principle that, in NSGOs, DFIs and MDBs undertake financing on terms and conditions normally obtained by private-sector investors for similar financing.