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AN AFRICA CREDIT RATING AGENCY (AfCRA)

KEY SHAPING THE NEW GLOBAL FINANCIAL ARCHITECTURE

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The shortcomings of the three dominant international credit rating agencies have been well debated globally and in Africa, governments have raised concerns over their biases against the continent. The growing appetite by governments to raise funding from international financial markets to close the funding gap is pushing African governments to find a solution to make international borrowing sustainable. This report thus explores the establishment of an African Credit Rating Agency (AfCRA) as part of the mechanisms of supporting African countries to improve their credit ratings. This is in line with the African Union Assembly Decision Assembly/AU/Dec.631 (XXVIII) of Heads of States and Governments adopted at its 28th Ordinary Session in January 2017. The African Union policy organs have resolved that, it is feasible to establish an AfCRA as an independent and private sector entity that is self-funded and self-sustaining. The key success factor for the AfCRA will be to provide rating services to 40% unrated African governments, over 90% unrated corporates and local governments. The entity will complement the coverage of the three dominant international rating agencies and provide an alternative on the ground assessment of sovereign risk on the continent, which could potentially reduce risk significantly.

BACKGROUND

The credit rating industry in is dominated globally by the three international credit rating agencies (CRAs)—Moody's, S&P, and Fitch—which control an estimated 95% of the credit-rating business globally. Credit ratings emerged in Africa in the early 1990s when South Africa was the first African country to receive a sovereign rating in 1994. From 2002 to 2006, the number of African countries with ratings rose from 10 to 22, when 12 more sovereigns received credit ratings, including with support from an S&P Global and United Nations Development Program (UNDP) collaborative initiative. To date, 32 African countries have a sovereign rating from at least one of the 'big three' rating agencies.

Studies have presented evidence that international CRAs are biased against African countries, and it has been presumed that credit rating analysts have preconceived opinions about rated entities, which ultimately filter through to the resulting ratings. Kempf and Tsoutsoura (2018)[i] presented evidence of significant influence of partisan perception on analysts' credit-rating decisions, with ratings more frequently adjusted downward when analysts were not affiliated with the political party in power. The findings in these studies imply that rating bias does exist, based on the pre-existing opinions of analysts. Thus, Mutize and Nkhalamba (2021)[ii] showed analysts' biases against Africa, as the majority of analysts covering the continent are based outside the continent, and are most likely to have pre-conceived opinions that filter through to credit ratings.

The challenges caused by international CRAs became more apparent as the financial health of many African countries came under tremendous strain during the COVID-19 pandemic. A record number of rating downgrades has been witnessed since March 2020 due to the COVID-19 pandemic, translating into increased debt-servicing costs over the medium to long term. Many African countries have missed the opportunity to participate in the G20 Debt Service Suspension Initiative for fear of being downgraded by the international ratings agencies. The same fear has also impeded countries from seeking debt restructuring under the Common Framework for Debt Treatments, announced in November 2023 by the G20 and the Paris Club, mainly because ratings agencies will classify them as defaulters. These developments have magnified the impact of the COVID-19 pandemic, which continues to place severe strain on the fiscal positions of countries.

The preceding discussion shows conspicuous shortcomings in international CRAs that need to be addressed. Amongst all the studies that explore the prospects of establishing an alternative rating agency, none explore the feasibility of establishing such an institution in Africa. The BRICS bloc only includes one African country, South Africa. This study thus explores the feasibility of establishing an African Credit Rating Agency (AfCRA) as part of the mechanism to support African countries during their post-COVID-19 recoveries.

WHY CREDIT RATINGS ARE IMPORTANT

African governments seek sovereign credit ratings (SCR) in order to access global capital markets in pursuit of their broader objectives, including fostering deeper local capital markets, raising capital for public infrastructure projects, attracting foreign direct investment, and supporting private sector access to global capital markets. International investors in global capital markets prefer to invest in Africa through Eurobonds[iii] because of the perceived instability of local currencies in emerging markets. The need to raise funds through Eurobonds has invariably forced African governments to yield to stringent conditions set as best practices and minimum requirements for capital market borrowing by market regulators, in order to issue sovereign bonds. Potential lenders of long-term international capital require borrowing countries to have a credit rating from at least one of the three dominant international CRAs, as evidence of adherence to best practices in terms of information disclosure, and to reach out to a wider base of potential investors. However, there is increasing dissatisfaction[iv] about the influence, approach, and methodology of the three international CRAs in assessing credit worthiness.

Most African countries were assigned an initial sovereign rating of sub-investment grade (junk status), except Botswana, Egypt, Libya, Morocco, Mauritius, Namibia, South Africa, and Tunisia, which were rated investment grade. Of the eight countries that initially received an investment grade sovereign rating, only two—Botswana and Mauritius—have managed to maintain it. Historical data shows that no African country has managed to move from 'junk status' to investment-grade rating. The sub-investment grade implies that African countries present high credit risks, and the bonds issued by those countries are highly speculative, hence their costs of borrowing are extremely high.

In a quest to either improve or maintain favorable SCRs, African states perceive that they must subject themselves to prescriptive fiscal and monetary policy recommendations from the international CRAs. Any government that crafts an economic policy that contradicts the contractionary prescriptive recommendations of the international CRAs consequently suffers the loss of being downgraded. These circumstances, in the view of African leaders, have taken away the economic freedom of credit-rated Africa governments, and their sovereignty to freely craft their preferred long-term expansionary economic policies without threat of sovereign downgrade. Hence, studies argue that the regulation of national economies has literally shifted from state governments to international CRAs, over which African developing countries have no control. These developments undermine the role of African states in the provision of essential public goods and services, such as healthcare and education to their

WHY ESTABLISHMENT OF AFCRA WAS PROPOSED

Africa's policymakers were increasingly dissatisfied with the approach and methodology of the three international CRAs. Criticisms include that rating agencies are quick to downgrade African countries but slow when upgrades are due; that they fail to accurately account for risk perception; that they don't consult adequately with stakeholders; and that they lack independence and have a subjective basis for rating opinions. Governments have also claimed that the agencies have significant influence on domestic policy direction as their rating assessments and risk factors in their methodologies incline towards austerity measures. The pessimistic approach of analysts based outside Africa has a bearing on negative biases in assessments of subjective risk factors, exaggerating credit risk.

A number of African governments have contested the ratings assigned to them, arguing that the ratings were contrary to macroeconomic developments in their countries. Other governments have also challenged the correctness of the ratings, as they were not discussed with any authorized representatives of the government. Table 1 summarizes some of the governments that have issued public statements against ratings assigned to them.

During the outbreak of COVID-19 on the continent, more than 25 African countries suffered negative credit rating actions. The world's biggest lenders, including the World Bank, the International Monetary Fund, the G20, the African Development Bank, and all Paris Club creditors, approved a debt service relief package for more than 25 African countries. The goal was to free up more than $20 billion that governments could use to buttress their healthcare and social services. The majority of governments did not participate in the G20 Debt Service Suspension Initiative and the Common Framework for fear that it would lead to credit rating downgrades. International CRAs downgraded Cameroon, Côte d'Ivoire, Ethiopia, and Senegal precisely because of their participation in the debt service relief programs. These rating downgrades eroded the benefits accrued from the debt relief, as countries have to pay more interest on the same volume of debt. The United Nations also criticized rating agencies for worsening debt sustainability in poor countries, further hindering countries' ability to finance budget deficits in the medium term through access to global capital markets. This was key in financing the post-pandemic economic recovery of African countries.

This has encouraged the idea of establishing an AfCRA as part of the medium to long-term solution to these challenges. China has its own state-owned rating agency, Dagong Global Credit Rating Company. The Arab countries are also calling for their own rating agency. In addition, the international CRAs continue to expand their businesses in Africa through acquisitions. They have been acquiring the rising domestic rating agencies that could possibly grow to challenge their oligopoly positions in the global financial structure. In 2022, Moody's acquired a majority shareholding in Global Credit Rating (GCR) – the largest rating agency headquartered in Africa. Moody's also has a significant stake in the Egypt-based Middle East Rating and the West African Rating Agency (WARA). These acquisitions are a huge setback for the development of alternative rating agencies to compete against the monopoly of the 'big three'.

As part of the broader mechanism of addressing these challenges with the three international CRAs, several African leaders have argued for an Africa Credit Rating Agency (AfCRA). Former President of Senegal, Macky Sall, during his tenure as the Chair of the African Union, called for the "creation of a Pan-African credit agency as the current international credit ratings are proving unjust to African countries." This was during the United Nations Economic Commission for Africa's (UNECA) 54th session of the Conference of African Ministers of Finance, Planning, and Economic Development (CoM2022), held in Dakar, Senegal, from May 11-17, 2022. Addressing the 35th Africa Union Summit held on February 5, 2022, in Addis Ababa, Ethiopia, the President of the Republic of Ghana, President Nana Akufo-Addo, who is also the Champion of the AU Financial Institutions, supported an AfCRA[vi] and condemned an attempt by international rating agencies to "impede the progress of his government in accessing funds for development through their continuing consequential stranglehold, which has affected the cost and access to capital markets for African countries".

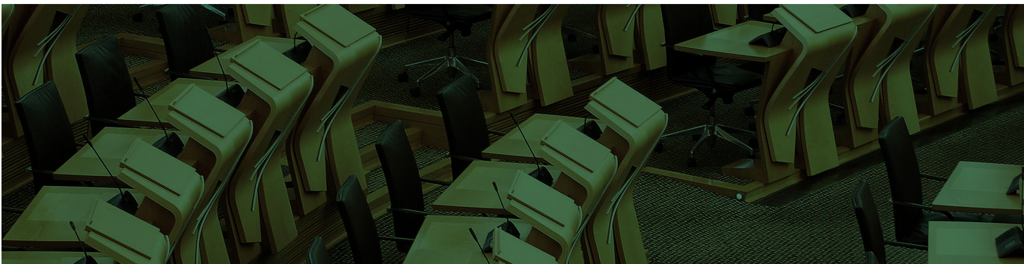
More recently, during the 2024 African Development Bank Group's (AfDB) Annual Meetings, the AfDB President, Akinwumi Adesina, Kenya's President William Ruto, and Rwanda's President Paul Kagame, all reiterated the need for an AfCRA as key in reforming the global financial architecture, which continues to be governed largely by the global North, and which does not fairly reflect Africa's needs. The presidents highlighted a pan-African rating agency as an important step towards complementing the AU financial institutions, accelerating intra-continental integration, providing capabilities for AU Member States to access capital, and integrating the continent into global financial markets, which relies significantly on credit ratings.

AFRICAN UNION OFFICIAL DECISIONS

The idea of establishing an AfCRA first emerged in March 2019 when African Union (AU) finance and economy ministers[1] adopted a declaration that such an institution is needed. As part of the process of establishing new institutions, the AU also developed a proposal on legal, financial, and structural aspects of the rating agency. Despite this common position, there was still no consensus on how the key challenges of medium to long-term sustainability, credibility, and independence of the agency would be overcome. However, after thorough consideration of the findings from research, the 6th AU Specialized Technical Committee (STC) of Ministers of Finance, Monetary Affairs, Economic Planning, and Integration, which was held on July 20-21, 2023 in Nairobi, Kenya, adopted a Declaration endorsing the "establishment of a private-sector driven Africa Credit Rating Agency (AfCRA) based on self-funding and sustaining".

The Ministerial Declaration called for the establishment of the rating agency outside the AU for credibility and independence. It is envisaged that an AfCRA will provide independent and accurate credit ratings for sovereigns, sub-sovereigns, and corporate entities, to support investor decision-making and promote fair competition between credit rating agencies. This will also facilitate affordable access to capital and the development of domestic financial markets, on the way to the AU Agenda 2063 of the "Africa we want".

[1]https://au.int/en/newsevents/20190304/3rd-stc-finance-monetary-affairs-economic-planning-and-integration-4-8-march



INSTITUTIONAL AND FINANCING MODEL

There are two main institutional models that the AU follows in establishing new institutions, which were considered for the AfCRA: establishing it as an Organ of the AU funded by member-state contributions or establishing it as self-funded Autonomous Specialized Agency of the AU. Given the nature of the credit-rating business, which requires credibility and independence, the option of an autonomous institution was suggested to be viable. Similar institutions with autonomous natures, with models that are being replicated by the pan-African rating agency, are the African Export-Import Bank (Afreximbank) and Africa Risk Capacity (ARC) agency. A summary of the legal, structural and financial model of the AfCRA is as follows:

- The rating agency will be an independent specialized agency of the AU, with shareholding of African Governments through direct ownership, or through their public institutions or their designated institutions, other Pan-African rating agencies, multilateral finance institutions, and African national financial institutions.
- On the financing structure, the agency will adopt the universally and scientifically established 'issuer-pay' business model, which is currently used in the credit-rating industry. It will be fully funded by its shareholders through seed capital from other Pan-African rating agencies, loans from Pan-African Financial institutions, and thereafter should be self-sustaining through revenue generated from its services.

This is proposed to ensure independence and credibility of the services of the agency.

THE BUSINESS CASE

In addition to the case expressed in the decisions of the Assembly regarding the need to support member states in international CRAs, there is a strong business case for an AfCRA. The AfCRA is an important step towards accelerating access to the international financial markets, thereby improving mobilization of resources and management of the financial sector. The envisaged AfCRA is also coherent with other AU specialized financial institutions: the African Investment Bank (AIB), the African Monetary Fund (AMF), and the African Central Bank (ACB). The agency will also facilitate trade, provide capabilities for AU member states to access capital, and integrate the continent with global financial markets, which makes tremendous reference to credit ratings.

An AfCRA will be key to the functioning and growth of African economies, based on developing a strong financial system with well-capitalized banking institutions and a corresponding strong support-services sector. The establishment of an AfCRA will provide alternative opinions to already rated 32 AU countries, and an opportunity to tap into the African countries that have no credit ratings from any of the three international CRAs, and possibility to assign local currency ratings for country-specific corporates, banks, financial institutions, and municipalities that have an interest in having an emerging CRAs. Despite the dominance of the 'big three' rating agencies globally, there are still 22 African countries that have no credit ratings from any of the three dominant agencies, and over 90% of corporates and municipalities remain unrated. This will be a clear niche for the pan-African rating agency, which is estimated at over $46 billion[2] in bond market capitalisation, together with the potential unrated market in the corporate and municipality space, which is growing exponentially. There is also tremendous value within the alternative rating sector, which includes small to medium-sized enterprises (SMEs), initial bond offerings, initial public offerings, environmental, social, and governance (ESG) scores, and foreign direct investment ratings, which the rating agency will service. These rating services are urgently needed on the continent to complement governments' efforts to support the development of domestic financial markets.

[2]https://www.pwc.co.za/en/assets/pdf/africa-capital-markets-watch-2021.pdf

The focus of the AfCRA will be to assign sovereigns ratings and local currency ratings to help develop domestic debt markets in different AU countries. AfCRA will provide the following product suite: Sovereign Ratings and Sovereign Fund Ratings, Local Currency Ratings

(Country Specific), and ESG Advisory and Assessment Services including Second Party Opinion.

Local Currency Ratings will include the following:

a) Bonds issued by Parastatal Bodies and Counties;
b) Green Bonds, Social Bonds, and Sustainability Linked Bonds;
c) SME Grading and Due Diligence;
d) Bank Facility Ratings—Fund-Based Facilities and Non-Fund Based;
e) Real estate investment trusts (REITs), Commercial Papers, Securitized Papers Ratings;
f) Bonds issued by Corporates, Financial Institutions, Banks and Development Finance Institutions (DFIs).

With the reputational leverage of affiliation to the AU, and support from African-based multilateral financial institutions such as the African Development Bank (AfDB), Development Bank of Southern Africa (DBSA), Africa Export Import Bank (Afreximbank), and others, there is a strong possibility that the AfCRA will be able to secure substantial business in the ratings of domestic instruments. This also aligns with Africa's long-term strategy for promoting access to affordable capital and promoting the development of domestic financial markets. Given the precedence of the few African-based rating agencies, which mainly assign ratings for domestic issuance, the AfCRA could have the distinctive advantage of having an Africa-oriented rating scale, a unique understanding of the domestic context of Africa, and issuing more informative and detailed ratings than international ratings issued by the 'big three'.

In addition, alternative rating opinions based on an African-oriented methodology and risk factors will be a basis for comparison against international standards. This will help accelerate continental integration and socio-economic development through the mobilization of resources and management of the financial sector for improved access to the international financial markets. An AfCRA will be pertinent in facilitating financial autonomy in line with Agenda 2063, Goal 20 of "Africa takes full responsibility for financing her development".

There is also tremendous value in the alternative rating sector, which cannot afford the cost of maintaining a rating from the international rating agencies. These rating services are needed urgently on the continent to complement governments' efforts to support the development of domestic financial markets. With the backing that comes from the support of the AU, it is envisaged that the rating agency will secure substantial business in the ratings of domestic instruments aligned with the continent's goals. It will have the advantage of understanding the domestic context of Africa, issuing more informative and detailed ratings than those

issued by the international rating agencies. AfCRA will operate independently of AU and will benefit from practices such as peer reviews and experience sharing.

It is envisaged that AfCRA will directly benefit AU member states through enhanced disclosures and a structured sovereign rating methodology, with the additional Sovereign Rating criteria (apart from GDP growth, domestic macroeconomic fundamentals including public debt, foreign reserves, current account balance, inflation, political risks and regime, exchange rate regime, state of monetary policy, that are considered traditional key determinants of sovereign risk premia). These additional criteria will accurately reflect macroeconomic fundamentals of member countries, transparency of budget processes and data transparency processes.

One of the prime indicators for success of AfCRA will lay in reducing country risk premiums and thereby reduce spreads on foreign currency bonds raised by respective sovereigns, to ensure that governments' financing needs are met at the lowest possible cost. The world has witnessed sub-investment grade ratings assigned to 85% of sub-Saharan African countries by the three dominant international CRAs between 2014-2021. These bonds are classified and rated as High Yield (HY) Bonds, indicating low-quality credit risk. Eventually, sensitivities on bond spreads will narrow down to the progress of the country and the willingness to repay the debt. Finally, greater success will be seen when AU Member States' sovereign risk premiums are benchmarked against global peers' risk premiums, with similar underlying sovereign ratings. The AfCRA will aim to reduce perceived higher risk notions with international investors reflecting higher confidence, thereby narrowing the gap between discriminatory behavior between African and non-African regions, rather than differences in macroeconomic fundamentals.

THE WAY FORWARD

The AU is forging ahead with its plans to establish a pan-African rating agency. As part of the implementation of the project, the African Union has recently achieved the following steps: first, engaged experts to interrogate the models; second, secured a technical partner; third, hired a transaction adviser; lastly, mobilizing shareholders.

Not withstanding reputation and credibility risks, in substantiating the need to establish an AfCRA, respondents have noted the following success factors. First, there is a need to facilitate greater access to alternative funding markets, and less reliance on traditional financing channels in the post-COVID-19 economic recovery phase. Second, an emerging market rating scale should be adopted to differentiate risk amongst member states and integrate the diverse economic potential in African countries. Third, there is potential to reduce borrowing costs in both rated and unrated countries because of increased information availability. Lastly, the lack of rating coverage in Africa's sub-sovereign, state-owned companies, municipal, corporate, and project ratings should be tackled. Additional rating coverage is much needed in wider sectors that have tremendous potential to unlock infrastructure development on the continent.

Although the AfCRA will have to overcome many challenges in order have investors' imprimatur, both domestic and international, with the huge appetite for an alternative and complementary credit rating institution in Africa, the AfCRA has greater chances of success.

i Kempf, E., & Tsoutsoura, M. (2018). Partisan Professionals: Evidence from Credit Rating Analysts. National Bureau of Economic Research Working Paper Series. Available [online] https://doi.org/10.3386/W25292

ii Mutize, Misheck, & Nkhalamba, M. P. (2021). A comparative study of economic growth as a key determinant of sovereign credit ratings in Africa. International Journal of Emerging Markets, 16(4), 786–805.

iii An international bond that is denominated in a currency other than the currency of the issuing country, usually denominated in United States Dollar, Euro or Pound.

iv https://www.aprm-au.org/wp-content/uploads/2021/03/21-International-credit-rating-agencies-in-Africa-perceptions-trends-and-challenges.pdf

v https://www.africanews.com/2022/05/16/au-chair-wants-pan-african-financial-rating-agency//

vi https://au.int/en/pressreleases/20220720/ghana-supports-establishment-african-credit-rating-agency

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