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APRM SUPPORT TO MEMBER STATES IN THE FIELD OF RATING AGENCIES – (AMSRA)

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Concept Note

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1. Introduction

This Concept Note presents an outline of the proposed APRM Support to Member States on International Credit Rating Agencies (AMSRA). The APRM Support to Member States obtains its mandate from the decisions of the African Union Assembly. The Assembly Decision Assembly**/AU/Dec.631 (XXVIII)** adopted at its 28th Ordinary Session held in Addis Ababa, Ethiopia in January 2017 directs the APRM to provide support to Member States in the field of Rating Agencies. The Decision is also collaborated by the decision on Institutional Reform of the African Union (Assembly/**AU/Dec606/(XXVII**) which states that; the APRM be strengthened to track the implementation and oversee monitoring and evaluation of key governance areas on the continent. This mandate includes the tracking of economic governance, including the specific area of international economic governance and market regulation on the continent. The decision is also collaborated by the African Union (AU) Assembly decision (Assembly***/AU/Dec.631(XXVIII)*** Clause 7(i)) made at the 28th Ordinary Session Assembly of the African Union in 2017, on the revitalisation of the APRM. The decision states that the APRM be repositioned to play a monitoring and evaluation role for the African Union Agenda 2063 and the United Nations Sustainable Development Goals Agenda 2030. The Decision provides that the APRM track governance aspects of AU Agenda 2063 Aspiration 1: A prosperous Africa based on inclusive growth and sustainable development; and Aspiration 7: Africa as a strong, united and influential player and partner. Accordingly, therefore, the APRM shall track the practices and impact of Credit Rating Agencies in their role of establishing capital standards for financial institutions in a global economy and as purveyors of sovereign credit rating.

The role of the APRM in tracking International Credit Rating Agencies in Africa, however, was first proposed at the 4th General Assembly of the Forum of Former African Heads of State and Government - Africa Forum held in Addis Ababa, Ethiopia on 2nd April 2016. In his address, the former President of the African Development Bank H.E Dr. Babacar Ndiaye, who is also a Member of the Africa Forum, indicated that "The APRM is a critical tool, a mechanism which should explore the possibility of playing the role of the Continental Rating Agency. We cannot have external people coming to rate us when we have such capable and competent Mechanisms like the APRM,"[1].

[1] African Union, 04 April 2016. Press Release: APRM Critical for Africa's Development Agenda. Retrieved from: https://au.int/en/pressreleases/20160404-0. 05 October 2018.

In pursuant of the above decisions, the APRM integrated the agenda in the APRM 2016 -2020 APRM Strategic Plan which was adopted at the 25th APR Forum of Heads of States and Government Participating in the APRM, held in Nairobi in August 2016. The Plan stipulates that the APRM should develop APRM Support to Member States on the role of regional and international ratings agencies and the role of the APRM in setting clear policy options, strategies and actions for its member states.

The Decision has now been effectively operationalised following an approval of the APRM Support to Member States by the Permanent Representatives Committee (PRC)[2], Sub-Committee on Finance and Administration at their meeting held on 15th November 2017 in Addis Ababa, Ethiopia. In implementing the decision, it is envisaged that the APRM will consult and engage member states, specifically, the Ministries of Finance and National Treasuries, Ministries of Economic Planning, the Central Banks and other national public financial institutions as determined by the member states.

2. Background

The Decisions to establish APRM Support to Member States in the field of rating agencies emerged from concerns over the impact of poor ratings in African Countries by the three leading ICRAs, namely: Standard & Poor's (S&P), Moody's, and Fitch – which are domiciled in the United States of America and the United Kingdom. These ICRAs provide Sovereign Credit Ratings (SCRs) in Africa, which aim to provide investors with specific insights into the creditworthiness or the ability to repay a borrowed amount together with interest, as well as the level of default risk associated with investing in a particular Organisation or Economy (Rhee 2015). The APRM Support to Member States on ICRAs is primarily interested in ICRAs Sovereign Credit Rating (SCR) as they are essential in determining the interest rates that a borrower entity or a government must pay in servicing its debt, thus affecting the cost of capital. The APRM Support to Member States is accordingly based and modelled on this premise.

2.1 The Role of International Credit Ratings

The APRM Support to Member States on International Credit Rating Agencies is a paramount pre-requisite to improve the continental financial architecture and access to affordable capital. The support

[2] "The Permanent Representatives Committee (PRC) conducts the day-to-day business of the AU on behalf of the Assembly and Executive Council. It reports to the Executive Council, prepares the Council's work and acts on its instructions (under article 21 of the Constitutive Act). All AU Member States are members of the PRC". (https://au.int/en/organs/prc)

would complement other AU instruments such as the 2009 African Investment Bank Protocol which aims to provide capital raising capabilities to Member States through the issuance and sale of both bonds and securities and assist in mergers and acquisitions operations.

The APRM Support to Member States on International Credit Rating Agencies will also derive from and inform the implementation of the 2014 Protocol on the Establishment of the African Monetary Fund, the 2012 Agreement for the Establishment of the African Risk Capacity (ARC) Agency, as well as the 1991 Treaty of Establishing the African Economic Community. The support to Member States recognises both the constructive and destructive role international credit rating agencies.

The constructive role of CRAs in Africa relates to Sovereign Credit Ratings which are useful in predicting a country's economic distress and inform financial markets to correctly apportion sovereign credit risk. In addition, the European Commission (2011) presents macroeconomic models showing evidence that sovereign credit upgrades affect positively a country's gross domestic product (GDP). Credit ratings are thus a measure of a country's economic strength and plays an important role in supporting greater public-sector financial transparency as sovereigns seek to improve their credit ratings to reduce borrowing costs and ultimately external debt. The recent default through concealment of debt volume and non-repayment by the Republic of Congo (Congo-Brazzaville) and Mozambique orchestrated to maintain its sovereign ratings and to access more funds has received huge attention (S&P 2017). This lack of full disclosure suggests that credit ratings still serve as a useful indicator of a country's credit risk profile. The Report cites imprudent spending and unexplained spending by the country's biggest state-owned enterprises as the main driver of the unsustainable debt which the country may not be able to service at least for the next five years. Hence, there is a legitimate concern on the dangers of increasing debt levels in most African countries that have widening deficits, unprecedented external borrowing at high interests to finance non-essential infrastructure (African Development Bank Group 2018).

According to the World Bank President Kim (2017), significant private sector financial resources are readily available and sitting on the sidelines of capital markets as investors have a natural tendency to remain generally risk-averse, hence the funds remain largely untapped. Investors therefore use credit ratings to sift through the growing number of bond issues based on a 'common language' of credit risk that was invented by the rating agencies. This means without credit ratings which assigns risk profiles, mountains of idle capital will remain largely untapped at the expense of real investments in tangible and productive assets such as equipment, machinery and plant. When capital borrowing in emerging economies is directed into the real sector, it builds the capacity of future real industrial production growth, real GDP growth, future real economic productivity which directly feed into improvement in health care, employment creation and extinguishing sovereign debt, which is haunting emerging countries, and Africa in particular. To investors, this information comes at very little or no cost and that is the basis on which confidence and positive sentiment is built.

International Credit rating Agencies also play a destructive role. The failures of the three dominant international CRAs have been unequivocally exposed during the financial markets collapse of New York City in the mid-1970s that caused the US real GDP growth to fall from 7.2% to -2.1%, the Asian financial crisis of 1997 – 1998 that costed Asian countries a combined 31.7% loss in nominal GDP, the Enron scandal of 2001 that resulted in shareholders, employees and creditors losing more than US$100 billion, and the global debt financial crisis of 2008 that costed over 10% loss of GDP in all major economies across the world, a dark moment in human history. In its findings on the causes of the 2008 financial crisis in the US, The Financial Crisis Inquiry Commission (2011) reported that "the financial crisis would not have happened without CRAs as mortgage-related securities that were at the center of the crisis could not have been marketed and sold without rating seal of approval. Finely honed CRAs' computer models accorded triple-A ratings to complex mortgage-backed securities that almost no one understood, and investment banks were paying handsome fees to the rating agencies to obtain the desired ratings. Prior to the crisis, the rating agencies placed market share and profit considerations above the quality and integrity of their ratings by deliberately disseminating inaccurate information about the probability of default of issuers".

2.2 International Credit Rating Agencies in Africa

Credit Rating Agencies provide a forward-looking opinion on the creditworthiness of an organization (public/private) or economy over its financial obligations, in terms of that organization or economy's ability and willingness to service its debts in full and due time, with respect to the agreed terms[3]: The notion of "creditworthiness" is defined as the presumed ability to meet agreed deadlines related to repaying the credit and the interest accrued without affecting the vitality of the borrower, or affecting adversely the financial situation, the financial results as well as other business or economic interests (Feschijan, 2008, p. 273).

Credit ratings typically distinguish between investment grade and non-investment grade (which is also called speculative grade or junk). This allows investors to restrict the purchasing of obligations below a particular credit rating. These ranking models seek to classify credits into groups which share common credit risk characteristics that can be treated as equivalent for decision-making purposes to manage

[3] Ministry of Finance-Capital Markets Division-India, 2009, Report of the Committee on Comprehensive Regulation of Credit Rating Agencies, India.

default risk, from best to worst using a scale or criteria to determine the appropriate credit class for the entity being evaluated. These ranking models seek to classify credits into groups which share common credit risk characteristics that can be treated as equivalent for decision-making purposes to manage default risk, from best (investment grade or AAA) to worst (high risk/junk) using a scale or criteria for determining the appropriate credit class for the entity being evaluated.

A credit rating profoundly influences lenders' decision. The resultant rate of interest or cost of capital charged by investors is severely dependent on the rating issued and marks a reference to evaluate the risk undertaken. Sovereign rating upgrades make it easier for banks to access funds from the capital and global market at a cheaper cost compared to rating downgrades (Mensah et al., 2017). Downgrades or poor ratings by CRAs lower investor confidence in African economies. However, research has shown that emerging economies have different risk and exposure landscapes (Parbhoo, 2015). Moreover, the Political economy climate in Africa and the associated determinants of sovereign credit ratings differ between African regions and income groups however, CRAs seldom assign a credit rating to a local municipality, provincial government, or private company that is higher than that of the issuer's home country. (Pretorius & Botha 2017).

Over the past two decades, Barta and Johnston (2017) contend that the changes in credit ratings of African countries do not reflect the average improvement in political, economic and social indicators. Sovereign rating statistics show that the international CRAs have downgraded more countries than they have upgraded in Africa[4] despite the Africa's average economic growth of 3.6 percent in 2017 (AfDB 2018). "Europe has seen the strongest improvement among all regions in its outlook balance since 2011. Over the past year, the outlook balance has deteriorated in Asia-Pacific and even more so in Latin America. Although the outlook balance in the Middle East, Commonwealth of Independent States (CIS), and Africa remains very high, but has somewhat improved over 2016 (to -10 from -12), the outlook for Africa is still appears to be in the negative (-10).

It should be noted, as depicted in Figure 1, 2 and 3 that African countries are assigned an initial sovereign rating grade BB (junk status) of sovereign ratings are far below those of developed countries, in "junk status" save for South Africa, Botswana, Morocco and Mauritius. This is true of all the three leading ICRAs. The following Figure 1 presents the SCR distribution in Africa

[4] 47 downgrades across compared to only 22 upgrades and 113 negative changes in outlooks compared to only 9 positive changes in outlooks.

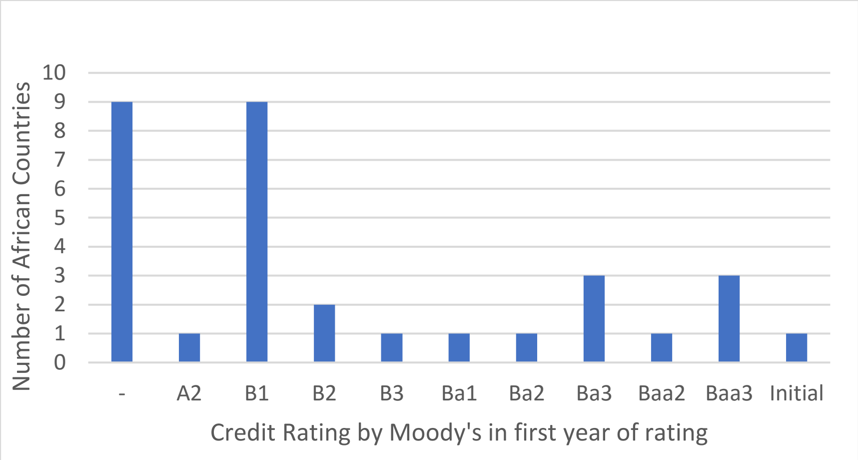

Figure 1: Credit Rating by Moody's in first year of rating

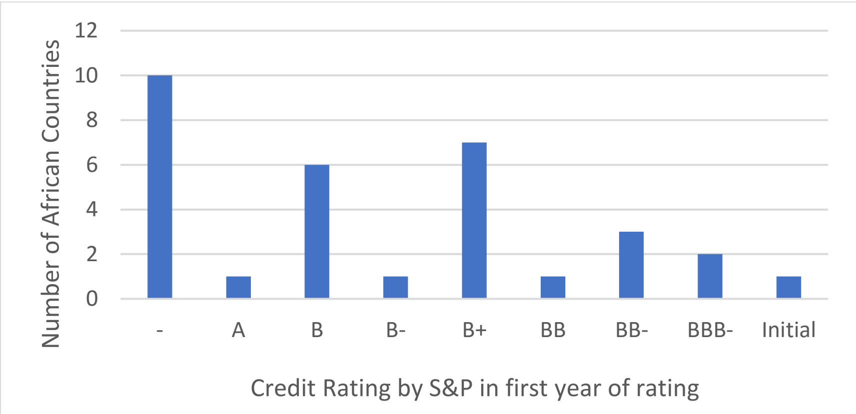

Figure 2: Credit Rating by S&P in first year of rating

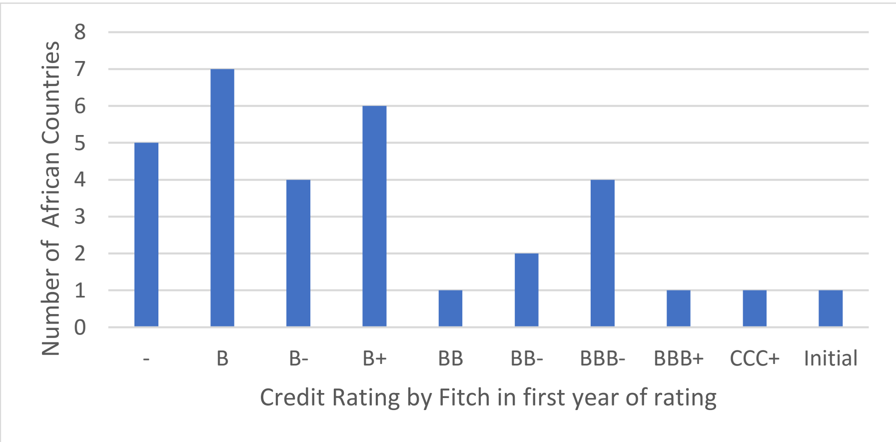

Figure 3: Credit Rating by Fitch in first year of rating

According to the IMF Regional Economic Outlook for sub-Saharan, the number of low-income countries facing a high risk of debt distress in the region, increased from 7 in 2013 to 12 in 2016. The report also noted that countries with Sovereign Credit Ratings, except Namibia, have been downgraded below investment grade (2017, p11). This is indicative of the need for an African-tailored CRA that takes local, regional and contextual indicators and determinants of creditworthiness into account.

The fundamental implications of these credit rating actions are that African economies are performing worse than they were before, a view contrary to the economic development, improved employment rate, financial deepening and industrialisation witnessed over the period. Once a country is downgraded, it takes an average of seven years to regain its previous sovereign rating grade. Studies show that most sovereigns that are downgraded are likely to experience a deterioration of its macroeconomic fundamentals and an increase in foreign currency borrowing costs.

It is important to take Advisory measures to reduce the over-dependence on and influence by ICRAs by African Countries. ICRAs continue to influence internal affairs of national governments in emerging markets such as those in the BRICS countries, as well as Africa.

The challenges relating to ICRAs in Africa may additionally include: dictating government policy, Regime change maniacs, Ignored economic potential in emerging economies, More downgrades than upgrades from ICRAs and Selective aggression; Difference in rating grades; Dominance and overreliance on the 3 lead ICRAs; Market Failures; CRAs Procyclical nature; Lack of objectivity; Human Bias; No Conclusive Proof of Soundness; and Concealment of Material Facts.

It is in this context that this Concept Note envisages that the outcome of the APRM Support to Member States on International Credit Rating Agencies in Africa will be the establishment of an advisory body governing the activities and practice of ICRAs on the continent and providing pre and post rating support to member states.

3. The APRM Support to Member States on International Credit Rating Agencies

3.1 Purpose

The aim of AMSRA is to articulate and implement the architecture for providing advisory services to member states. In this respect the APRM shall undertake routine and periodic political economy analysis of the nature and extent of the ICRAs' influence and practices of the leading three International Credit Rating Agencies in Africa, and/or managing and regulating their practices. The APRM Support to Member States further seeks to provide advisory and other support services to African governments pre and post rating processes.

3.2 Key Activities

In implementing the support, AMSRA will undertake routine and periodic political economy analysis of the nature and extent of the ICRAs' influence and practices of leading International Credit Rating Agencies operating in Africa and provide avenues for redress. In pursuing this objective, as part of the support to Member States, the APRM will undertake processes to create an instrument and institutions. Such an instrument would be a Protocol or Policy Framework and would guide an institution with one or more of the following mandates; i) regulation and supervision – a continental regulatory body or securities and markets authority; ii) credit rating services – a continental rating agency; iii) capacity development – a technical support facility; and iv) advisory services – a continental advisory body.

Following the approval of the APRM Support to Member States by the AU Permanent Representatives Committee, the APRM designed and is implementing through a broad-based state and non-state partnership framework, a 3-year process to be implemented through 4 Components.

3.1 Component One: Research on ICRAs

The APRM facilitates assessments and undertakes research in four thematic areas: Democracy and Political Governance, Economic Governance and Management, Corporate Governance and Socio-Economic Development. Each thematic area focuses on selected aspects of the promotion and establishment of good democratic governance standards and practice as defined by the African Union. These then materialise into institutions which act as the supportive architecture on which governance can be measured.

Cognisant of the political and socio-economic aspects, the APRM Support to Member States on ICRAs is substantively guided by the APRM thematic areas of Economic Management and Governance, as well as Corporate Governance. The thematic areas The APRM Economic Governance and Management theme interrogates the efficacy of the broad national economic policy framework, the institutions, processes and practices in place that are aimed at facilitating and supporting the establishment of an economic climate that translates into equitable and sustainable economic growth. The APRM Corporate Governance theme address all aspects that govern a company or firm's relations with shareholders and other stakeholders. It is concerned with the ethical principles, values and practices that facilitate the balance between economic and social goals, individual and communal goals, and public and private interests. The aim is to align as much as possible the interests of private individuals, corporations and society within a framework of sound governance and common good.[5]

[5] As defined in Paragraph 4.1 Objectives, Standards, Criteria and Indicators document (NEPAD/HSGIC-03-2003/APRM/Guidelines/OSCI 9 March 2003). APRM, 2017, Corporate Governance, from: http://www.AU.org/corporate-governance

In line with the APRM's niche of Afro-centric philosophy and institutional character, APICRA will be further be guided by the principles of legitimacy and credibility defined among others as African-grown, African-led and African-owned.

To secure this character, APICRA will be implemented in partnership with the University of Cape Town (UCT) Business school; the African rating agencies WARA and Bloomfield Investment (Ivory Coast); Agusto & Co (Nigeria); the Chamber of Commerce (South Africa); African Regional Faculty of Commerce Institutions; BRICS Financial Services Group as well as various other African Banks, Central Banks, treasuries and Ministries of Finance.

3.1.1 Key Outcomes

This first Component will develop various research products, including:

a) Background Paper
b) Policy Research Papers
c) Policy Briefs/Insights
d) An Annual Report on International Credit Rating Agencies in Africa

3.2 Component Two: Experts Forum on Credit Ratings

The second Component provides for a series of convenings, platforms and engagements in the format of Forums on International Credit Rating Agencies. In this regard the APRM will thus organise an Annual Experts Forum.

The Experts Forum shall be a platform of renown experts: academics and policy practitioners from government, business schools, universities, multilateral agencies and industry. These experts shall meet to consider reports and undertake evaluations of the performance of the proposed African Credit Rating Advisory body (should it be established), national level institutional reforms and trends in the practice of CRAs. It is envisaged that the Experts Forum will be operationalised through an annual technical workshop and/or conference event.

1.2.1 Key Outcomes

The proposed outcomes from the Experts Forum will be:

a) A Baseline Report on ICRAs in Africa recommended for adoption by AU Assembly;
    i. Develop and review the framework for the Advisory body of CRAs;

ii. Develop recommendations that will be presented to African Union Member States at the AU Assembly.

b) A Framework and TORs for the Establishment of the African Union ICRAs Advisory Body recommended for AU Assembly adoption

c) Approved African Union Annual ICRAs Reports from the Advisory Body

1.3 Component Three: Development of an AU Instrument on International Credit Rating Agencies

The APRM Support to Member States will explore the feasibility of developing a protocol, regulation and policy framework on a common approach to the regulation and supervision of ICRAs within the African Union. The instrument would define the approach necessary to enhance the integrity, responsibility, good governance and independence of credit rating activities to ensure quality ratings and high levels of investor protection. Such an instrument would also describe the most important laws and self-regulations that should be a turning point for the rating industry in this century, influencing CRAs' formal recognition, corporate governance and functioning. Due reference would be made to the existing IOSCO Principles and Code of Conduct, External Credit Assessment Institutions (ECAI) and the Basel II Accords and the US the Credit Rating Agency Reform Act (CRARA) of 29 September 2006.

1.3.1 Key Outcomes

The key outcomes of this Component will include:

a) An African Union Framework for International credit Rating Agencies

b) A Protocol and Regulation on Credit Rating Agencies

1.4. Component Four: Support to the establishment of a continental body on International Credit Rating Agencies in Africa

African governments have sought sovereign ratings in pursuit of objectives such as fostering deeper local capital markets, raising capital for public infrastructure projects, attracting foreign direct investment and supporting private sector access to the global capital markets (United Nations Economic and Social Council 2014). The third Component of AMSRA will focus on rationalising the engagement of African States with International Credit Rating Agencies. It envisages to establish an African Agency on ICRAs. This work under this Component shall provide institutional and technical support to the proposed establishment of an African agency, association, and Advisory body for ICRAs fashioned comparably along the European Association of Credit Rating Agencies (EACRA), the European Financial Stabilisation Mechanism (EFSM), the European Securities and Markets Authority (ESMA) or the European Financial Stability Facility (EFSF). The feasibility of such institutions in Africa hinge on the establishment of an African Investment Bank, an African Central Bank and attainment of other economic integration objectives such as the establishment of a common currency.

1.4.1 Key Outcomes

The key outcomes of this Component will include:

c) Registration of the Continental Advisory Body on ICRAs
d) Supporting the establishment of a Continental Advisory Body on ICRAs in Africa.

1.5 Component Five: Country Assessment - Targeted Reviews

Under this Component, the APRM will undertake, upon request and/or commission, targeted reviews on various aspects related to CRAs in Member States. The APRM Targeted Review, unlike the base reviews which are conducted in APRM member states only, take place in both APRM and non-APRM Member states. The purpose of the Targeted Review is to undertake focused assessments of one specific area in an African country. The Targeted Reviews allow African Countries undertake an assessment of an element, or aspect of one of the APRM thematic areas, or a cross cutting issue, which both the APRM and the government deem a priority and critical for governance and development. The proposal to undertake Targeted Reviews as part of APICRA, presents an opportunity to African countries to assess aspects and elements of the political economy; institutional, policy and politico-administrative, regarding Sovereign Credit Rating by ICRAs in African countries.

It is envisaged that the implementation of Targeted Reviews on various aspects of International Credit Rating Agencies will be guided by all four APRM thematic areas and the AU Agenda 2063 framework. Any African country can request for a Targeted Reviews before a country invites an International Credit Rating Agency to conduct Sovereign Credit Ratings or after an ICRA has published their opinion. The Targeted Reviews will produce a short and concise report in a short period of ten (10) days.

5.1.1 Key Outcomes

1. Periodic Country Reports on ICRAs ratings commissioned and developed under the Targeted Review

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