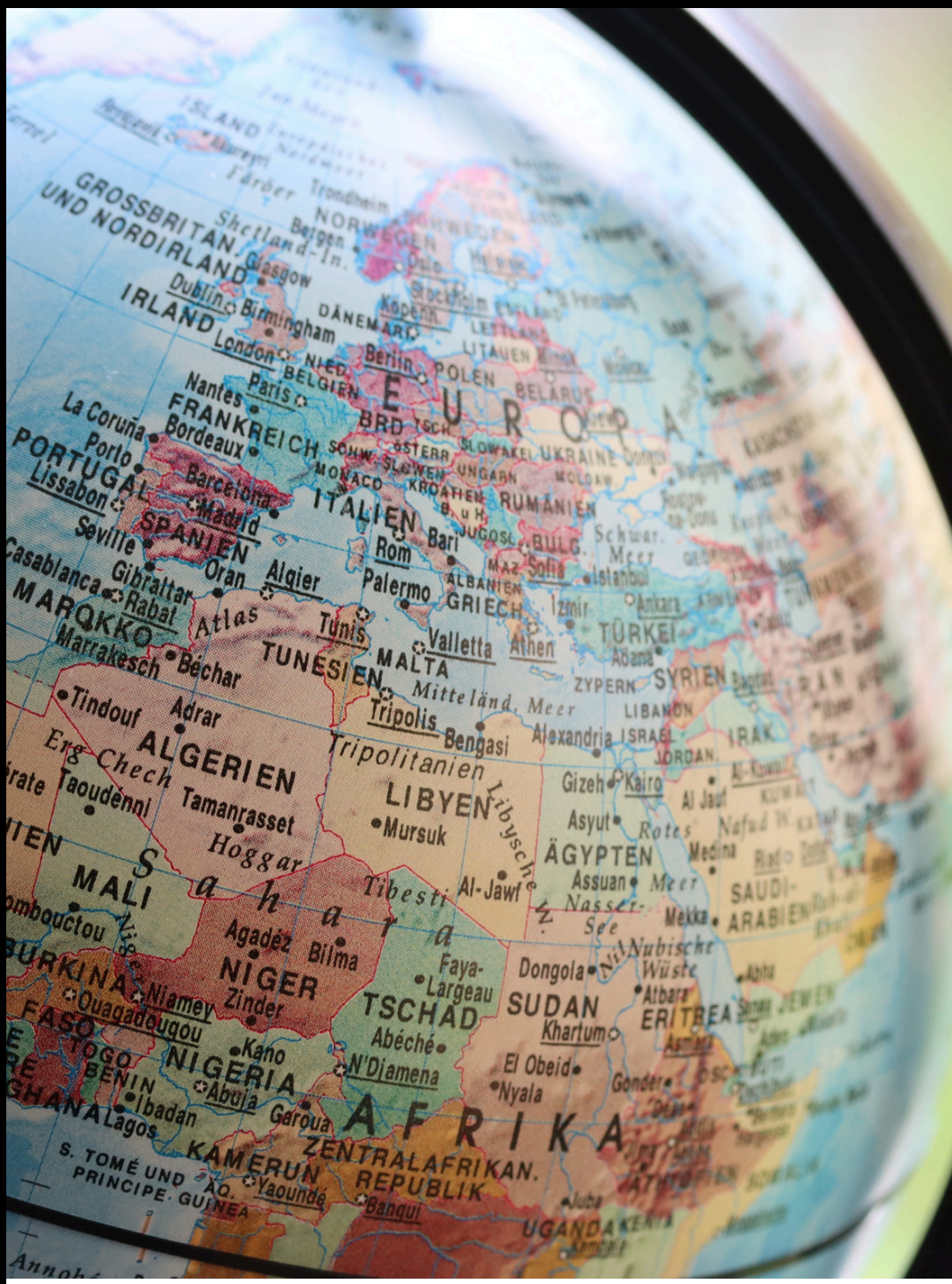
Development Finance in Africa and the Institutionalized Risk Premium



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Abstract

The notion of an “African risk premium” has often been understood narrowly as an outcome of market perception, driven either by bias or by beliefs about structural weaknesses in the region. This study develops a new framework for understanding the premium by introducing the concept of an “institutionalized” African risk premium. In doing so, the study identifies three distinct forms of the African risk premium: (a) the perceived African risk premium; (b) the real African risk premium; and (c) the institutionalized African risk premium. The latter is “institutionalized” in the sense that it is rooted in regulatory frameworks that govern the global financial market. It is therefore not a matter of what the market thinks of the continent, but rather what it is compelled to do. Drawing on the cost of capital theory, the study proves the presence of the institutionalized component by examining how current regulatory capital frameworks applicable to internationally active banks and insurance companies reinforce the risk premium.

It is of profound importance that the institutionalized component of the premium is recognized so that the solutions proposed are effective. Building on the clear framework it establishes for understanding the premium, this study proceeds to assess the effectiveness of the new African Credit Rating Agency (AfCRA) in addressing it. The study argues that, while AfCRA can address the perceived component, it has limited scope to address the real and institutionalized risk premiums. This is not a criticism of AfCRA. Rather, the study reflects that the premium problem is multifaceted, and addressing it requires interventions on various levels. In the context of the institutionalized premium, genuine cooperation is necessary between African institutions and the predominantly Western institutions that shape the global rule-making process. Such cooperation is essential not only for recalibrating how risk is assessed and priced but also for ensuring that the global financial system supports, rather than constrains, sustainable development on the continent.

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1. Introduction

Africa is currently grappling with two existential threats. On the one hand, the continent faces an estimated US$1.3 trillion annual shortfall in the finances required to achieve its basic Sustainable Development Goals (SDGs) by 2030.[1] In 2024, the Climate Policy Initiative reported that only 23% of the estimated annual funding required to implement Africa's climate targets is currently being met.[2] On the other hand, the continent is so heavily indebted to external lenders that it now spends more than one-quarter of total government revenues on interest payments alone.[3] As a result, many countries in the region are prioritizing debt repayments at the expense of development.[4] These dual crises appear contradictory: how can a region so deprived of funds be at the same time burdened with so much debt? Yet, both are true, and they share a common enabler: the African risk premium.[5] This premium refers to the additional borrowing costs imposed on African governments and institutions, not just due to actual economic conditions but also due to an assumed higher risk associated with the continent.[6] The risk premium's impact on debt financing for African states is severe and well-documented. A 2023 United Nations Development Programme (UNDP) report estimates that it adds US$74.5 billion to the annual cost of African sovereign debt.[7] A former African Development Bank (AfDB) president observed in 2024 that "[t]he cost of raising capital in Africa is three or four times what it is in other regions" because of the premium.[8] The notion that the African risk premium is a major barrier to development finance on the continent has been widely discussed.[9]

[1] United Nations Development Programme (UNDP), Sustainable Finance Report: Africa 21 (UNDP, 2025), https://sdgfinance-report.undp.org/assets/SDGFinance-Report.pdf.

[2] Climate Policy Initiative, Landscape of Climate Finance in Africa 2024, p. 17 (CPI, 2024). According to a former African Development Bank President, this funding problem "has become dire and is 'choking' the continent." African Development Bank (AfDB), AfDB 2023 Annual Meetings (May 2025), https://am.afdb.org/en/press-releases/african-development-bank-2023-annual-meetings-african-development-bank-chief-says.

[3] Afreximbank, African Debt Outlook: A Ray of Optimism, 3 Mkt. Update 8–9 (Feb. 2025).

[4] Daniel Cash & Maha Khan, Rating the Globe: Reforming Credit Rating Agencies for an Equitable Financial Architecture 10 (United Nations University, 2024); UNCTAD, Debt Crisis: Developing Countries' External Debt Hits Record $11.4 trillion (Mar. 17, 2025), https://unctad.org/news/debt-crisis-developing-countries-external-debt-hits-record-114rillion#:~:text=Developing%20countries%20are%20sinking%20deeper,99%25%20of%20their%20export%20earnings.

[5] See, e.g., United Nations Economic Commission in Africa, Economic Report on Africa 2025, p. 123 (Mar. 2025) (describing the premium as a "notable barrier" to development finance in Africa).

[6] See, e.g., Michael Olabisi & Howard Stein, Sovereign Bond Issues: Do African Countries Pay More to Borrow?, 2 J. Afr. Trade 87 (2015). Using data from 112 countries between 2006 and 2014, this study found that sub-Saharan African (SSA) countries pay nearly 2.9 percentage points more in interest rates when issuing sovereign bonds, even after accounting for relevant indicators like the issuers' credit ratings, their macroeconomic factors, and bond characteristics. An earlier study found that SSA countries were overcharged by 3.38 percentage points above what was justified by economic realities. See C. Gueye & A. Sy, Beyond Aid: How Much Should African Countries Pay to Borrow?, 24 J. Afr. Econ. 352 (2014). See Part I infra for further discussion.

[7] UNDP, Reducing the Cost of Finance for Africa: The Role of Sovereign Credit Ratings 39 (UNDP Report, Apr. 2023). See alsoAfDB, African Economic Outlook 2025, p. 66 (2025).

[8] AfDB, AfDB President Adesina Looks Back After Eight Years at the Top (June 2024), https://www.afdb.org/en/news-and-events/afdb-president-adesina-looks-back-after-eight-years-top-72168.

[9] See a review of the literature in Part I infra.

However, the various forms this premium takes have not been fully explored. Existing discussions describe it as a “perception” problem, largely reflected in credit ratings. For instance, the AfDB has referred to it as both a “perception gap” and a “myth.”[10] Other commentators, by contrast, view it as non-discriminatory but real and justified due to the region’s structural weaknesses.[11] While this categorization has its merit, it captures only part of the problem.

This report develops a novel framework for understanding the African risk premium. It introduces a new driver of the premium, which it terms the institutionalized African risk premium, and distinguishes this driver from the two that are already recognized in the literature. In doing so, the paper identifies three distinct forms of the African risk premium: (a) the perceived African risk premium, which is driven by market bias; (b) the real African risk premium, which is driven by structural weaknesses in parts of the region; and (c) the institutionalized African risk premium. The latter is “institutionalized” in the sense that it is rooted in regulatory frameworks that govern the global financial market. It is therefore not a perception that falls within the discretion of market participants, but a set of rules that must be followed. While the first two forms of the risk premium (i.e., the perceived and real components) have received attention in the literature,[12] the third has been overlooked. Yet, it is of profound importance that institutionalized risk premiums are recognized. Perceived risk premiums are merely symptoms of a deeper problem. The root cause lies in the regulatory structures that financial institutions and credit rating agencies themselves are required to follow.

Recognizing this distinction is therefore essential for fully understanding the African risk premium and evaluating ongoing efforts to address it. Without such clarity, proposed solutions may fall short. This is particularly true of the proposed African Credit Rating Agency (AfCRA), which is set to launch in September 2025.[13] AfCRA is expected to provide fairer and more accurate credit assessments of African entities and to challenge the dominance of external rating agencies that apply the risk premium.[14] While this initiative has value, this paper argues that it faces significant limitations. AfCRA only addresses the perceived risk premium and has very limited capacity to tackle the real and institutionalized components.

[10] AfDB, Africa’s Risk Premium: A Costly Myth Holding Back a Continent (Feb. 2025), https://www.afdb.org/en/news-and-events/press-releases/africas-risk-premium-costly-myth-holding-back-continent-80966. See also Olabisi & Stein, supra note 6, at 87–109.

[11] See, e,g., William Gbohoui, Rasmane Ouedraogo & Yirbehogre M. Some, Sub-Saharan Africa’s Risk Perception Premium: In the Search of Missing Factors, IMF Working Papers (June 2023). See also UNDP Report, supra note 7, at 24.

[12] A review of the literature is provided in Part I infra.

[13] Finance in Africa, African-led Credit Rating Agency Delays Launch to September, CEO to be Named Soon (June 9, 2025), https://financeinafrica.com/news/african-rating-agency-launch-september/.

[14] See Press Release, African Union, African Leaders Convene on Establishment of Homegrown Solution, The Africa Credit Rating Agency 1 (Feb. 7, 2025), https://au.int/sites/default/files/pressreleases/44406-pr-AFRICA_CREDIT_RATING_PR.pdf.

Drawing on the theory of the cost of capital, this paper offers a conceptual analysis of the institutionalized African risk premium. It examines how international financial regulations —particularly those governing capital requirements for internationally active banks and insurers—reinforce the African risk premium in ways that do not necessarily manifest through credit ratings. In doing so, the paper highlights how global regulatory structures contribute to the high cost of development finance in Africa.

The paper is structured as follows: Part I provides a systematic analysis of the nature and drivers of the African risk premium. It identifies the various stages at which the premium arises and assesses prevailing explanations for its persistence. This section questions the view that the premium is fully justified by structural weaknesses in the region and challenges the corresponding solution, which places the responsibility for addressing the premium solely on domestic reforms by African states. Part II introduces the concept of the institutionalized African risk premium. It examines it through the lens of regulatory capital requirements for banks and insurance companies. Drawing on the theory of the cost of capital, this section demonstrates how current prudential frameworks reinforce the risk premium. It also introduces the concept of the "African climate risk premium," which arises from how climate-related financial risks are calculated under these frameworks.[15] Part III evaluates the African Union's proposed solution through AfCRA and assesses its potential effectiveness. It argues that while the proposal may address elements of the perceived risk premium, it has a very limited scope when it comes to addressing the real and institutionalized components. To address the African climate risk premium, this part recommends incorporating what it terms a "climate supporting factor" into the methodology for calculating risk weights assigned to investments in Africa. The study concludes with a summary of key findings and recommendations.

The institutionalized African risk premium manifests in various forms and across multiple regulatory regimes. This study does not seek to address all dimensions of the premium or the full range of policy responses it may require; such an undertaking lies beyond its scope. Instead, the analysis focuses on regulatory capital requirements applicable to internationally active banks and insurers. These institutions are dominant participants in the Eurobond market, which has become the principal source of African sovereign debt and development finance and therefore provides a suitable focus for analysis.[16]

[15] See Part II.3(c) infra for more discussion.

[16] Eurobonds are debt instruments issued in a currency that is different from the domestic currency of the bond issuer. Despite the name, Eurobonds are not limited to Europe or to bonds denominated in euros. According to a recent UNDP report, total African Eurobond issuances have grown to approximately US$300 billion over the past two decades. UNDP, Sovereign Credit Ratings: Perspectives for Africa's Development 10 (Aug. 2025). For a discussion of the dominant role of Eurobonds in African sovereign debt, see footnotes 136–43 infra and the accompanying text.

The ultimate aim of this study is to develop a conceptual framework that opens new lines of inquiry into other manifestations of the institutionalized African risk premium and the potential policy responses they may require.[17]

Part I. AFRICAN RISK PREMIUM: PERCEIVED AND REAL

I.1 Nature and evolution of the risk premium:

African governments and companies pay additional borrowing costs (or premium costs) when raising finance from international markets. These elevated costs are not solely driven by macroeconomic fundamentals—such as economic growth, debt levels, or default histories—but also by assumptions that the region carries higher investment risks. As a result, the coupon (or interest rate) on a bond issued by an African entity is typically higher than that of a comparable bond issued by a peer from another region.

The existence of this premium is well-documented; so too are its serious implications for the flow and cost of development finance in Africa.[18] While the practice has a long history, it received formal expression in 2003 when many African states began to acquire sovereign credit ratings under a UNDP-funded African Sovereign Credit Rating Initiative, which led to the rating of thirteen African states by 2004 and eventually thirty-two by 2022.[19] According to the UNDP, the initiative aimed "to motivate Africa to compete for global private equity and debt flows with other developing economies."[20] Yet, in a seemingly contradictory outcome, all but two of the thirty-two ratings assigned as of August 2022 were non-investment grade (the exceptions being the ratings awarded to Botswana and Mauritius).[21] This was disappointing, as an investment-grade rating is often necessary for bonds to attract investors in capital markets, while non-investment-grade bonds must offer exorbitantly high yields to attract investor interest.[22]

[18] See infra in Part I for discussion of the literature.
[19] UNDP Report, supra note 7, at 13–14. Prior to 2003, South Africa had obtained a credit rating (since 1994) in the region. Trading Economics also suggests that Morocco received a credit rating from S&P as of 1998. See Trading Economics, Morocco–Credit Rating (Sep. 2025), https://tradingeconomics.com/morocco/rating.
[20] UNDP Report, supra note 7, at 14.
[21] Id. See also Stephany Griffith-Jones & Moritz Kraemer, Credit Rating Agencies and Developing Economies, UN-DESA Working Paper No. 175, p. 3 (Dec. 2021), https://www.un.org/en/desa/credit-rating-agencies-and-developing-economies. Historically, only four African countries (South Africa, Morocco, Botswana, and Mauritius) have received investment-grade ratings from at least one of three major credit rating agencies—namely, Moody's, S&P, and Fitch Ratings. However, the ratings of South Africa and Morocco were downgraded in 2020 to non-investment grade, partly due to the economic impact of COVID-19. As of the time of this writing (Sep. 20, 2025), the number of African countries with an investment-grade rating remains unchanged. See UNDP, Sovereign Credit Ratings, supra note 16, at 6; Trading Economics, Credit Rating: Africa (June 2025).
[22] Hippolyte Fofack, The ruinous price for Africa of pernicious 'perception premiums,' Africa Growth Initiative at Brookings 2 (Oct. 2021), https://www.brookings.edu/wp-content/uploads/2021/10/21.10.07_Perception-premiums.pdf.

More concerning, however, was the rationale given by the credit rating agency, S&P Global Ratings (S&P), for these ratings. In its 2004 report, S&P stated that African states face a challenge of "investor perceptions" about their entrenched macroeconomic and social fragility.[23] The significance of this admission by a major credit rating agency (hereafter, CRA) is difficult to overstate. It suggests that these ratings were derived not only from the usual objective factors but also from subjective assessments that impose premium risks on the region beyond what would be expected based on its actual risk profile.

This practice appears to have continued in recent years. Griffith-Jones and Kraemer provide evidence suggesting a potential bias in the CRAs' treatment of sub-Saharan Africa (SSA) during the COVID-19 pandemic.[24] While advanced economies and Central and Eastern Europe (CEE) experienced virtually no downgrades (less than 5%, and around 2%, respectively), the SSA region was hit hardest, with 41% of sovereigns downgraded, despite advanced economies experiencing a deeper contraction and a steeper rise in debt during the pandemic.[25] S&P rating action was even more telling, as it downgraded 50% of SSA countries while offering forbearance to all other regions.[26] These developments enabled advanced economies and CEE countries to access ample, low-cost market financing during and after the crisis, while SSA countries faced limited and prohibitively expensive access, making recovery from the pandemic particularly challenging for the latter.[27] These downgrades have also made it harder for SSA countries to raise development finance from the market, as the negative ratings persist and continue to inflate borrowing costs.[28]

But the premium does not stop at the grading stage. Evidence shows that it persists beyond agency ratings. A comparison between the 10-year bond yields of Botswana and Greece is illustrative.

[23] S&P Global Ratings (S&P), Sovereign Ratings in Africa (S&P New York, 2004).
[24] Griffith-Jones & Kraemer, supra note 21, at 4–6.
[25] See International Monetary Fund (IMF), World Economic Outlook: A Long and Difficult Ascent 9, 31 (Oct. 2020), which estimates that advanced economies contracted far more than emerging and developing market economies in 2020, and shows the surging aggregate government debt ratio of advanced economies.
[26] Fofack, supra note 22, at 5 (noting that the region emerged from the pandemic with more than 93% of its sovereigns rated as sub-investment grade borrowers, with only two countries—Botswana and Mauritius—retaining investment grade ratings).
[27] United Nations (UN), Financing for Sustainable Development Report 2022, p. 23 (UN, 2022), https://financing.desa.un.org/sites/default/files/2023-04/FSDR_2022_0.pdf. See also Misheck Mutize, Why Downgrading Countries in a Time of Crisis is an Exceptionally Bad Idea, The Conversation (Apr. 30, 2020), https://theconversation.com/why-downgrading-countries-in-a-time-of-crisis-is-an-exceptionally-bad-idea-136863.
[28] The downgrades triggered a number of protests from SSA countries against the CRAs. See, e.g., African Sovereign Debt Justice Network, Seventy-Third Sovereign Debt News Update: Kenya Joins Calls for the Reform of Global Credit Rating Architecture amidst Adversity, Afronomicslaw.Org (Mar. 2023), https://www.afronomicslaw.org/category/african-sovereign-debt-justice-network-afsdjn/seventy-third-sovereign-debt-news-update.

Despite Botswana holding higher credit ratings from both S&P and Moody's Investors Services (Moody's) (i.e., BBB+ and A3, respectively) than Greece (BBB and Baa3), Botswana's yields are projected to be significantly higher by 5.09%.[29] A more striking comparison can be made between Argentina's dollar-denominated 100-year Eurobond issued in 2017 and South Africa's dollar-denominated 30-year Eurobond issued the same year. Argentina, which had a sub-investment grade rating and has defaulted on its debts multiple times (including in 2001 and 2014), [30] was charged a coupon rate of 7% for its 100-year bond.[31] By contrast, South Africa's bond carried a higher coupon of 8.75%, despite its investment-grade rating, its shorter maturity, and the fact that it has not defaulted on its sovereign debt since 1985.[32]

Empirical studies in this area have also produced consistent results that the premium persists beyond agency ratings. Olabisi and Stein analyzed how different indicators affect the yields countries pay when they issue bonds, using data from 112 countries between 2006 and 2014.[33]

"...SSA countries pay nearly 2.9 percentage points more in interest rates when issuing sovereign bonds, even after accounting for relevant indicators like the issuers' credit ratings, their macroeconomic factors, and bond characteristics–meaning, for example, that if similar countries paid 5% interest, SSA countries paid around 7.9%."

[29] See, respectively, World Government Bonds, Botswana, https://www.worldgovernmentbonds.com/country/botswana/, and Greece, https://www.worldgovernmentbonds.com/bond-historical-data/greece/10-years/#google_vignette.
[30] Ben Bartenstein, Sydney Maki & Marisa Gertz, One Country, Nine Defaults: Argentina Is Caught in a Vicious Cycle, Bloomberg(May 2020), https://www.bloomberg.com/news/photo-essays/2019-09-11/one-country-eight-defaults-the-argentine-debacles#:~:text=It%20had%20failed%20to%20put,of%20Ecuador%2C%20Uruguay%20and%20Turkey.
[31] How Did Argentina Pull Off a 100-year Bond Sale?, Fin. Times (June 20, 2017), https://www.ft.com/content/5ac33abc-551b-11e7-9fed-c19e2700005f.
[32] South Africa had an investment-grade rating of Baa3 (according to Moody's), while Argentina had a sub-investment rating of B3. See, respectively, Trading Economics, https://tradingeconomics.com/south-africa/rating, and https://tradingeconomics.com/argentina/rating.
[33] Olabisi & Stein, supra note 6.

They found that SSA countries pay nearly 2.9 percentage points more in interest rates when issuing sovereign bonds, even after accounting for relevant indicators like the issuers' credit ratings, their macroeconomic factors, and bond characteristics—meaning, for example, that if similar countries paid 5% interest, SSA countries paid around 7.9%.[34] More recently, Gbohoui et al. analyzed 1,592 international (sovereign) fixed coupon bonds issued between 2003 and 2021 by eighty-nine countries (including fourteen countries from SSA) and reached a similar conclusion that SSA countries pay a "significantly higher" coupon at issuance beyond what traditional determinants of yields (including credit ratings) can explain. [35] They also found that SSA countries pay higher refinancing costs in the secondary markets, making bonds emanating from the region extremely costly to issue and relatively illiquid in the secondary market.

I.2 Drivers of the risk premium:

Part I.1 above presents evidence, both from the literature and relevant market actors, that the African risk premium exists at both the grading and post-grading stages. But what are the drivers of this premium? In other words, what factors explain why African states are often charged more to borrow from international capital markets, even when their economic fundamentals are comparable to those of better-rated peers? This is an area where the debate is inconclusive. Two opposite views are popular in the literature.

The first attributes the premium to "perceptions" and "bias," which cannot be justified by any quantitative or qualitative assessment factors.[36] Olabisi and Stein argue that the said 2.9% premium that SSA countries pay "may only be described as a penalty on African governments due to investor bias."[37] Morsy and Moustafa analyzed the bond yields and credit default swap (CDS) spreads for fifty-five countries, including seventeen African states, from 2004 to 2019, and found evidence of sovereign risk mispricing and investor herding for African debts.[38]

[34] Id. at 96 et seq. An earlier study found that SSA countries were overcharged by 3.38 percentage points above what was justified by economic realities. See Gueye & Sy, supra note 6, at 352–66. To put this into perspective, by the end of 2015, the cumulative value of Eurobonds issued by SSA countries stood at US$20.8 billion. See John Mbu, Why Eurobonds are an Important Source of Finance for Africa (WEF, 2016). Using the more conservative 2.9% estimate from Olabisi and Stein, this implies that these countries paid approximately US$603.2 million in excess interest annually. As the average bond maturities spanned ten years, this translates to a net loss of more than US$6 billion to African countries on their Eurobond obligations.

[35] Gbohoui, Ouedraogo & Some, supra note 11.

[36] See, e.g., Geoffrey Adonu, Towards Closing Africa's Climate Financing Gap: Scaling African Governments' Access to the Sustainable Bond Market, in Transforming Climate Finance in an Era of Sovereign Debt Distress 156 (James Thuo Gathii, Adebayo Majekolagbe & Nona Tamale eds., Sheria Publishing, 2024).

[37] Olabisi & Stein, supra note 6, at 99.

[38] Hanan Morsy & Eman Moustafa, Mispricing of Sovereign Risk and Investor Herding in African Debt Markets, AFDB Working Paper Series No. 33 (2020).

More importantly, using the Blinder-Oaxaca decomposition approach, they showed that the mispricing "is mainly due to discriminatory behaviour by international investors rather than to differences in the quality of macroeconomic fundamentals."[39] This "perception" or "bias" view has also been expressed by notable institutions, including the AfDB.[40]

The second view, on the other hand, suggests that the premium is neither discriminatory nor a mere perception. Rather, it is justified if other non-traditional determinants of bond yields are taken into account. Gbohoui et al.'s empirical study is the leading and most recent contribution supporting this view.[41] While their study confirms that SSA countries face higher borrowing costs than their non-SSA peers, it also finds that this premium largely disappears when structural challenges, such as weak domestic financial systems, reduced fiscal transparency, the large size of the informal economy, and the weak quality of institutions, are taken into account.[42] This finding is significant. It suggests that what is often referred to as the African risk premium may, in fact, reflect underlying structural qualitative factors that explain the higher borrowing costs. However, the study's scope has limitations.

As discussed above, the risk premium arises both when credit ratings are assigned and afterwards. Gbohoui et al.'s analysis uses the credit rating at the time of issuance as one of the control variables, meaning it does not account for the premium arising at the rating stage: only the post-rating premium is assessed. This implies that structural factors may not explain the disproportionately lower credit ratings assigned to the region. Furthermore, while the structural factors used to explain the risk premium are not negligible, attributing the entire premium to these factors risks oversimplifying the issue. Using Olabisi and Stein's conservative estimate, this implies that the structural factors alone account for the full 2.9 percentage point premium, representing nearly half of the historical average coupon rate (7.3%) for Eurobonds issued by SSA countries.[43] An earlier study placed the premium at 3.38 percentage points.[44]

[39] Id. at 1, 21.
[40] AfDB, supra note 10 (describing it as both a "perception gap" and a "myth"). See also Fofack, supra note 22, at 2.
[41] Gbohoui, Ouedraogo & Some, supra note 11. See also UNDP Report, supra note 7, at 24, which suggests that the premium is mainly influenced by methodological idiosyncrasies of the credit rating agencies.
[42] Gbohoui, Ouedraogo & Some, supra note 11, at 18 et seq.
[43] Fitch Solutions, Return to International Capital Markets Belies Persistence of Fiscal Risks in Sub-Saharan Africa (Oct. 2024). This historical average has been used to match the estimated premium point, which itself was based on an old date. The premium point is likely to be higher today, given the significant increase in borrowing costs and the COVID-19 downgrades faced by the region. The current average coupon rate is 8.5%; see id.
[44] See Gueye & Sy, supra note 6.

These figures are significant when compared to the proportion of the coupon rate accounted for by more objective domestic and global macroeconomic factors, which have been found to be more important determinants of spreads.[45] Moreover, if structural challenges were the dominant cause of the risk premium, one would have expected a system whereby countries with greater structural difficulties consistently face higher premiums across all regions. However, the analysis does not adequately account for both inter- and intra-regional variability that presently exists in this respect.

Consider, for instance, the abovementioned comparison between Argentina and South Africa, where South Africa issued a bond at a higher coupon rate despite its stronger credit rating, shorter bond maturity, and better default history. Even after controlling for the structural factors highlighted by Gbohoui et al., the yield differential remains difficult to justify. In fact, South Africa outperformed Argentina on all structural indicators at the time of issuance, including fiscal transparency,[46] strength of domestic financial institutions,[47] quality of institutions,[48] and the size of the informal economy.[49]

[45] See, e.g., António Afonso, Pedro Gomes & Philipp Rother, What “Hides” Behind Sovereign Debt Ratings?, ECB Working Papersno. 711 (Jan. 2007), which finds that the relevant explanatory variables for a country’s credit rating are GDP per capita, GDP growth, government debt, government effectiveness indicators, external debt, external reserves, and default history. See also Balazs Csonto & Iryna Ivaschenko, Determinants of Sovereign Bond Spreads in Emerging Markets: Local Fundamentals and Global Factors vs. Ever-Changing Misalignments, IMF Working Paper (July 2013).
[46] See, e.g., International Budget Partnership, Open Budget Survey 2017, Annex D (IBP-OBS, 2018), https://internationalbudget.org/wp-content/uploads/open-budget-survey-2017-report-english.pdf. Annex C shows a consistently strong performance from South Africa since 2006, and recent reports confirm this trend; see, e.g., the 2023 survey, https://internationalbudget.org/wp-content/uploads/rankings-charts-OBS-2023.pdf.
[47] In 2017, the Organisation for Economic Co-operation and Development (OECD) Economic Survey noted that Argentina’s financial sector was “less developed than in other countries.” OECD, OECD Economic Surveys: Argentina 2017: Multi-dimensional Economic Survey 24 (OECD Publishing, 2017), https://doi.org/10.1787/eco_surveys-arg-2017-en. By contrast, South Africa’s financial system in the same year was considered to be “highly developed.” See OECD, OECD Economic Surveys: South Africa 2017, p. 95 (OECD Publishing, 2017), https://doi.org/10.1787/eco_surveys-zaf-2017-en. More recently, Moody’s affirmed South Africa’s Ba2 rating and kept it on a stable outlook, citing the country’s “effective, core institutions such as the judiciary and the central bank, a robust, deep financial sector and a solid external position” as reasons. Moody’s affirms South Africa’s Ba2 rating amid economic challenges and political change, Reuters (Dec. 4, 2024), https://www.reuters.com/world/africa/moodys-affirms-south-africas-ba2-rating-amid-economic-challenges-political-2024-12-03/.
[48] Based on the World Bank's Worldwide Governance Indicators (WGI) for 2017, South Africa was considered to have stronger institutional quality than Argentina on all indicators, including rule of law and government effectiveness. See South Africa Country Governance Indicators (1996–2017), https://www.ceicdata.com/en/south-africa/country-governance-indicators, and Argentina Country Governance Indicators (1996 – 2017), https://www.ceicdata.com/en/argentina/country-governance-indicators.
[49] Argentina had a larger informal economy than South Africa in 2017, accounting for approximately 29.6% of its GDP, compared to 24.9% for South Africa. See World Economics, Informal Economy Size (2017), https://www.worldeconomics.com/Informal-Economy/Argentina.aspx (Argentina), and https://www.worldeconomics.com/National-Statistics/Informal-Economy/South%20Africa.aspx (South Africa).

This strengthens the argument that structural factors alone do not fully explain the premium. All of these suggest that additional variables (outside the traditional macroeconomic fundamentals, institutional variables, and structural factors) are at play in the pricing of SSA bonds. This is where the “perception” or “bias” view becomes relevant.

The Financial Times notes that “it is hard to ascertain how much of this premium might reflect misguided perceptions, or realities around idiosyncratic political risks and structural economic challenges.”[50] I agree. And in light of the analysis in the preceding paragraph, it cannot be said that structural weaknesses in the region fully explain the premium.

The foregoing qualification of the “structural justification” finding is important not just because the finding oversimplifies the issue but also because it advocates for structural reforms by SSA countries as the way to address the risk premium. Structural reforms are undoubtedly important. However, focusing solely on domestic reforms without acknowledging the external factors that contribute to the risk premium places an undue burden on SSA countries to carry the entire responsibility for their elevated borrowing costs. It overlooks the fact that even countries making significant progress in governance, financial-sector development, and transparency may still face disproportionately high premiums due to global market dynamics and investor perceptions.

I.3 Concluding statement:

So far, the two dominant views in the literature have been discussed regarding the drivers of the risk premium on SSA bonds. The first is the perception (or bias) view, which attributes the premium to market perceptions or bias. The second is what I refer to as the “structural justification” view, which argues that the premium is warranted due to structural weaknesses in SSA economies and institutions. However, there is a third driver that, to the best of my knowledge, has received no attention in the literature. I refer to this as the “institutionalized” risk premium. The following section discusses this premium.

[50] Does Africa Need Its Own Credit Rating Agency?,” Fin. Times (Oct. 29, 2024), https://www.ft.com/content/1bbf3aa8-04b5-4292-8a64-06c136a22fb8.

Part II. INSTITUTIONALIZED AFRICAN RISK PREMIUM

II.1 Initial comments:

The institutionalized African risk premium arises from the provisions of global financial rules. It can manifest in several ways. It may arise from the cost of regulatory capital, where established risk-weighting methodologies lead to higher capital charges for African exposures.[51] It may also appear in the form of compliance costs—where, for example, international rules on financial crimes treat financial flows to and from the continent as high risk.[52] Furthermore, it may arise from how risk itself is conceptualized and quantified in regulatory frameworks, including in the context of environmental, social, and governance (ESG) and climate-related financial risks, where global standards tend to rely on data and assumptions that place the continent at a disproportionate disadvantage.[53] More broadly, it may emerge as a result of constrained funding options or a lower appetite among investors to engage with African markets on affordable terms, as regulatory requirements diminish the continent's attractiveness as a destination for global capital.

Importantly, institutionalized risk premiums are not necessarily the product of bias on the part of rulemakers. Rather, they partly reflect a global order whose rules and metrics were largely designed outside the African context yet applied universally.[54] The result is a structural asymmetry: African economies bear a disproportionate share of the costs associated with global risk regulation and capital allocation. Addressing this imbalance therefore requires more than domestic reform or regional initiatives; it calls for collaborative engagement between African countries and the predominantly Western institutions that shape the global rulemaking process. Such cooperation is essential not only for recalibrating how risk is assessed and priced but also for ensuring that the global financial system supports, rather than constrains, equitable and sustainable development in Africa.

[51] See Parts II.2 and II.3 infra for further discussion.
[52] A possible case in point is the Financial Action Task Force regime.
[53] A good example of this manifestation is what this paper terms "the African climate risk premium." See Part II.3(c) infra for discussion.
[54] An example of this outcome in the context of international taxation is the dominance of the OECD Model Tax Convention, which was originally designed to favor the interests of capital-exporting countries (mostly resident states or developed economies) over those of capital-importing countries (i.e., source states or developing economies). See Ivan Ozai, Between Legitimacy and Justice in International Tax Policy, in Tax Justice and Tax Law: Understanding Unfairness in Tax Systems 188 et seq. (Dominic de Cogan & Peter Harris eds., Hart Publishing, 2022). There has been a recent attempt to include non-OECD members in the rulemaking process through the OECD's "Inclusive Framework." Ozai considers this attempt to be more about "fostering public perception of inclusiveness" and less about "increasing their actual participation" in the rule-making process. See id. at 193 et seq.

This part examines how the institutionalized African risk premium operates through the regulatory capital rules applicable to internationally active banks and insurance companies—namely, the Basel III and Solvency II frameworks. Before discussing both frameworks as drivers of the African risk premium, it is first necessary to briefly describe the nature of the regulatory capital regimes.

II.2 Overview of the regulatory capital frameworks and the cost of capital theory:

The primary objective of the capital frameworks is to ensure that banks and insurance companies are adequately capitalized to absorb financial losses while continuing to meet their obligations to depositors, policyholders, and other counterparties when they become due.[55] As such, the frameworks require these institutions to hold adequate capital (mostly shareholders' equity) against investments exposed to financial risks. In other words, the more a project is perceived to be exposed to financial risks, the more costly it will be to obtain bank funding (either through loans or bond issuance) or insurance products (such as CDSs) for the project.

Basel III sets out global capital standards for banks[56] and was developed by the Basel Committee for Banking Supervision (BCBS or the Basel Committee), the primary global standard setter for banking supervision.[57] Meanwhile, the Insurance Capital Standard (ICS) sets out capital standards for internationally active insurance groups (IAIGs). It was developed and recently adopted on December 5, 2024, by the International Association of Insurance Supervisors (IAIS).[58]

[55] See, e.g., Basel Committee on Banking Supervision (BCBS), Basel III: Finalising Post-crisis Reforms 1 (Dec. 2017), https://www.bis.org/bcbs/publ/d424.pdf.
[56] Its full provisions are contained in BCBS, The Basel Framework (BIS, 2024), https://www.bis.org/baselframework/BaselFramework.pdf.
[57] The Basel Committee was formed in Sep.1974 by the governors of the central banks of the Group of Ten (G10) countries. It now comprises forty-five members across twenty-eight jurisdictions, mainly from developed economies, with South Africa being the only African member. The committee assists national authorities in strengthening the supervision of internationally active banks. While the implementation of the Basel framework is only advisory, and even member countries of the Basel Committee are not bound to enforce it, the framework is generally adopted by many supervisory authorities worldwide due to the extensive consultative process and expertise involved in its development. For a more detailed account of the historical development of the committee's work see Charles Goodhart, The Basel Committee on Banking Supervision – A History of the Early Years 1974–1997 (Cambridge University Press, 2011).
[58] For an overview of the main objectives and components of the Insurance Capital Standard (ICS), see Bank for International Settlements and Financial Stability Institute, ICS – Overview – Executive Summary, FSI Connect (2024), https://www.bis.org/fsi/fsisummaries/ics_overview.pdf.

The provisions of Basel III and the ICS are extensive[59] and cannot be exhaustively discussed in this study. As such, the discussion here will necessarily be selective. First, the capital analysis will mainly focus on credit risks.[60] Indeed, as will become apparent, much of the existing work by regulators, banks, and other commentators in this area has focused on credit risks, which are more relevant to this study.[61] Second, it should be noted that Basel III and the ICS only prescribe minimum capital standards.[62] National supervisory authorities are free to adopt tailored frameworks that reflect local circumstances while remaining broadly comparable to these global standards, and the extent to which this occurs varies across jurisdictions.[63]Therefore, for simplicity, the following analysis will be based mainly on the Basel III and ICS standards, with references to individual authorities included where relevant. In the context of the latter point, the EU Solvency II framework will be the primary reference when discussing the capital framework under the ICS. This is partly due to its widespread implementation [64], partly because the ICS has not yet been fully adopted by many national jurisdictions, given its recent adoption, and partly because the ICS largely reflects the key elements of the EU's Solvency II.[65]

[59] For example, the complete consolidated version of Basel III numbers more than 1,800 pages. See The Basel Framework, supra note 56.
[60] Credit risk is the risk of loss due to a counterparty failing to meet its debt obligations.
[61] Other categories of risks, which the frameworks address, include market risks, operational risks, reputational risks, and insurance risks (for insurance companies). See The Basel Framework, supra note 56, at 142 et seq., 1280 et seq.; International Association of Insurance Supervisors (IAIS), Insurance Capital Standard 42 et seq. (Dec. 2024),
[62] See, e.g., IAIS, Insurance Capital Standard as a Prescribed Capital Requirement, Consultation Paper 9 (2023).
[63] For example, the state insurance regulators in the US have decided not to implement the ICS, after raising concerns about the ICS's market-based valuation approach, the exclusion of certain financial instruments from qualifying as capital, and its failure to account for jurisdictional differences within the US. Instead, they decided to implement an alternative approach that provides comparable outcomes to the ICS. See Board of Governors of the Federal Reserve System and U.S. Department of the Treasury, Report to Congress: The Impact of the International Insurance Capital Standard on Consumers and Markets in the United States(Nov. 2024). By contrast, the EU's existing regulatory approach (i.e., Solvency II) is largely consistent with the ICS. See European Insurance and Occupational Pensions Authority (EIOPA), EIOPA Welcomes International Agreement on a New Global Capital Standard for Insurers (Nov. 14, 2024), [35] Martens, supra note 29..
[64] Solvency II directly governs insurance and reinsurance companies in all thirty countries of the European Economic Area (EEA). Its legal framework is set out in Directive 2009/138/EC (Solvency II Directive), with detailed requirements elaborated in the Commission Delegated Regulation (EU) 2015/35 (Solvency II Regulation). These standards have been largely retained in the UK's domestic regime following Brexit. See IMF, Possible Unintended Consequences of Basel III and Solvency II International Monetary Fund (IMF, Aug. 2011), which notes at para. 2 that "Solvency II has also implications beyond Europe through, for example, its influence on the international standards being developed by the IAIS, and because external insurance groups will be more easily able to operate in the EU if their home supervisory regimes are considered equivalent." The US, by contrast, operates a different system known as the Risk-Based Capital (RBC) framework, which is generally viewed as less comprehensive than Solvency II.
[65] See, e.g., EIOPA, Final Boarding Call for the ICS (Sep. 14, 2023), [35] Martens, supra note 29..

Basel III and Solvency II each have two capital objectives: micro-prudential and macro-prudential objectives. The former is firm-specific and designed to keep individual banks/insurers resilient against financial losses. The macro-prudential objective, on the other hand, is designed to maintain the financial system's resilience. Here, the focus is not necessarily on the exposures of the relevant entity. Instead, the focus is to identify the build-up of risks in the financial system and to prescribe relevant capital that will be held against those risks.

Basel III sets out two categories of capital to meet these objectives. The first is a minimum capital requirement of 8% of risk-weighted assets (RWAs), with at least 4.5% required to be met with the bank's own funds (i.e., common equity capital and retained profits).[66] This achieves the micro-prudential objective by aligning a bank's capital with its individual risk profile. The second category, which achieves the macro-prudential objective, includes various capital buffers (e.g., capital conservation and countercyclical and systemically important banks' buffers) of up to 8.5% RWAs, all of which must be funded by common equity and retained profits.[67] These buffers are designed to strengthen resilience during economic downturns and mitigate systemic risks.[68]

Under the Solvency II rules, two key capital thresholds are set out for insurers: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The SCR represents the amount of capital an insurer should maintain to withstand unexpected losses over the coming year, with a confidence level of 99.5%.[69] By contrast, the MCR marks the minimum capital level below which the insurer's financial position would pose an unacceptable risk to policyholders.[70] This minimum is set to ensure an 85% chance that the available capital will be sufficient to absorb losses over a one-year period.[71]

If an institution's capital falls below the Basel III minimum capital requirements or the Solvency II MCR, then severe regulatory actions can be triggered, including the potential withdrawal of the institution's authorization.[72] In the same vein, breaching the Basel III capital buffers or the Solvency II SCR carries serious consequences, but these focus on restoring financial resilience. For the Basel III buffers, restrictions are imposed on dividend distributions, share buybacks, and bonus payments.[73] In the case of the Solvency II SCR, the institution is required to develop and implement a recovery plan to rebuild its capital position within a specified timeframe.[74]

[69] Solvency II Directive, supra note 64, at arts. 100–01.
[70] Id. art. 129.
[71] Id.
[72] See, e.g., id. art. 144.
[73] See, e.g., The Basel Framework, supra note 56, at para. RBC30.2 et seq., for the capital conservation buffer.
[74] Solvency II Directive, supra note 64. at art. 138.

It is important to emphasize that both banking and insurance capital frameworks are primarily risk-based. For instance, under the Basel III minimum capital requirement, the amount of capital a bank must hold against a given exposure depends on the exposure's risk weight, not just its nominal value. Therefore, a Eurobond exposure valued at US$100 million with a 0% risk weight would require no regulatory capital. Conversely, if the exposure carries a 100% risk weight, it will require US$8 million in capital (using the 8% minimum capital requirement), of which at least US$4.5 million must be funded by the bank's own funds (namely, common equity—or ordinary shares—and retained profits). This means that lending to entities deemed risky is more capital-intensive for banks, compared to lending to lower-risk entities.

The risk-based approach not only strengthens banks against financial losses but also disincentivizes risky lending by making it more expensive. In practice, when a bank chooses to provide such funding, all or part of the cost of maintaining regulatory capital (hereafter, "capital cost") is often passed on to the borrower through higher interest rates, thereby increasing their cost of borrowing.[75]

In the context of Solvency II, capital costs can arise either from an insurer's direct investment in bonds or from its provision of insurance products that mitigate financial risks associated with those bonds. Both issuers and investors commonly use such products in the Eurobond market.[76] For example, the bond issuer might purchase currency swaps from an insurer to hedge foreign exchange risk that arises from currency disparities inherent in Eurobond markets. Investors, on the other hand, may purchase CDSs to hedge the issuer's credit risk. The insurer needs to factor in the capital cost associated with holding or selling these instruments. This capital cost is directly linked to the credit risk of the underlying asset. In the case of a CDS, the cost is determined by the issuer's credit risk. The higher the credit risk of the issuer, the greater the capital charge required under Solvency II. If the insurer chooses to sell the CDS, the capital cost is typically passed on to the investors via a higher CDS spread—that is, the premium payable by the investor for the CDS. Investors may, in turn, factor this higher spread into their bond-pricing models, which can increase the bond's overall yield in both the primary and secondary markets.

The phenomenon that banks' and insurers' regulatory capital costs are often passed on to counterparties is based on the theory of the cost of capital.

[75] John Armour et al., Principles of Financial Regulation 437 (Oxford University Press, 2016).
[76] See, e.g., AfDB, "Stylized Facts and Lessons from West Africa's Eurobonds, AFDB Blog (Jan. 5, 2016), https://blogs.afdb.org/measuring-the-pulse-of-economic-transformation-in-west-africa/post/stylized-facts-and-lessons-from-west-africas-eurobonds-15276 (see the last para.).

This theory holds that a firm's investment and pricing decisions are guided by the minimum rate of return required to maintain or increase its market value—that is, the return necessary to satisfy its providers of funds (both debt and equity), given the risk associated with its financing and investment structure.[77] In the case of banks and insurers, regulatory capital mainly comes from common equity investors who demand returns commensurate with the risk they bear.[78] These expected returns represent the cost of regulatory capital and, therefore, a component of the institution's overall cost of funding.[79] When a particular exposure attracts a higher capital charge under Basel III or Solvency II, the institution's effective cost of funds for that exposure rises. To maintain profitability and meet investor return expectations, banks and insurers transmit this additional cost to their clients through higher lending rates, insurance premiums, or derivative spreads.[80] The result is that the regulatory capital framework itself becomes a structural determinant of financing costs.

It is important to emphasize that banks and insurers play a significant role in the Eurobond market, whether as direct investors, market makers, or providers of financial products (such as a CDS).[81] According to an International Monetary Fund (IMF) study, "[s]overeign bond yields and credit default swaps (CDS) are the most common variables widely considered as comprehensive measures of countries' overall risk premium."[82] Because these institutions are key participants in the Eurobond market and are required to hold capital against their bond exposures, their approach to valuing and pricing these bonds directly affects bond yields.

II.3 Regulatory capital as a driver of African risk premium:

How, then, are risk weights determined? This is the point where the regulatory capital frameworks begin to emerge as a key driver of the African risk premium.

[75] John Armour et al., Principles of Financial Regulation 437 (Oxford University Press, 2016).
[76] See, e.g., AfDB, "Stylized Facts and Lessons from West Africa's Eurobonds, AFDB Blog (Jan. 5, 2016), https://blogs.afdb.org/measuring-the-pulse-of-economic-transformation-in-west-africa/post/stylized-facts-and-lessons-from-west-africas-eurobonds-15276 (see the last para.).
[77] Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Am. Econ. Rev. 261, 288 et seq. (1958).
[78] Regulatory capital may also be funded through retained profits, in which case the cost of capital would be the opportunity cost of holding the profits as capital rather than investing them elsewhere to earn a return.
[79] Walter Kielholz, The Cost of Capital for Insurance Companies, 25 Geneva Papers Risk & Ins. 4 (2000). For banks, see Emily Beau et al., Bank Funding Costs: What are They, What Determines Them and Why do They Matter?, Bank of Eng. Q. Bull. 1, 5 (2014, Q4).
[80] See Modigliani & Miller, supra note 77, at 288 et seq.
[81] According to the Bank of International Settlements (BIS), insurance companies hold over 20% of their total assets in sovereign bonds. See Bettina Farkas et al., Insurance Companies' Holdings of Sovereign Debt, BIS Q. Rev. (Mar. 2023), https://www.bis.org/publ/qtrpdf/r_qt2303z.htm.
[82] Gbohoui, Ouedraogo & Some, supra note 11, at 6.

Under Basel III and Solvency II, risks are calculated using two primary methods: the standardized method and the internal method.[83]

II.3(a) The standardized method

This method is referred to as the Standardized Approach under Basel III and the Standard Formula under Solvency II. The method assigns risk weights to sovereign and corporate exposures mainly based on credit ratings issued by eligible external credit assessment institutions (ECAIs).[84] In practice, the ECAIs most commonly used by banks, particularly for assessing borrowers in emerging or frontier markets, are the three major international CRAs: Moody's, S&P, and Fitch Ratings (Fitch) (hereafter, the big three CRAs).[85]

Under this method, the lower the credit rating, the higher the risk weight and, consequently, the greater the capital charge required. The Basel III-adopted ratings and their corresponding risk weights for sovereigns are outlined in Tables 1 and 2 below.

Table 1. Basel III Standardized Approach: Risk weights for sovereign exposures [86]

External rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weight	0%	20%	50%	100%	150%	100%

[84] The Basel Framework, supra note 56, at para. CRE20.1(2); Solvency II Regulation, supra note 64, at art. 4.
[85] These are private companies headquartered in the US, but they account for 95% of the global ratings market. See Does Africa Need Its Own Credit Rating Agency?, Fin. Times (Oct. 29, 2024); UNDP, Sovereign Credit Ratings, supra note 16, at 5.
[86] The Basel Framework, supra note 56, at para. CRE20.7.

Table 2. Basel III Standardized Approach: Risk weights for general corporate exposures [87]

External rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	75%	100%	150%	100%

AAA to BBB- ratings are classified as investment grades, while BB+ and below are considered non-investment grades, or junk.
Under the Basel III Standardized Approach, exposures rated below B- attract a 150% risk weight because they are considered extremely high risk. By contrast, unrated exposures are assigned a 100% risk weight, as the Basel Committee considers that the absence of a rating does not necessarily indicate a very high credit risk and seeks to avoid disproportionately penalizing unrated entities. (See, e.g., BCBS, International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version [Bank for International Settlements, June 2006], paras. 66–68.)

The same principle applies to Solvency II's Standard Formula, in that the risk weight increases as the borrower or asset is deemed riskier. However, the presentation of the ratings and corresponding risk weights (or, more precisely, risk factors) is somewhat complex. Table 3 below provides a streamlined presentation applicable to a bond with a 10-year maturity.

Table 3. Solvency II Standard Formula: Risk factors for loans and bonds [88]

Credit quality step	0	1	2	3	4	5 and 6	Unrated
Risk factor stress	7%	8.50%	10.50%	20%	25%	41.70%	23.50%

[87] Id., paras. CRE20.42 and CRE20.43.
[88] Solvency II Regulation, supra note 64, at arts. 176(3) & (4).

The credit quality step scale ranges from 0 (the highest quality) to 6 (the lowest quality), with an additional category for unrated exposures.

The risk factor values are calculated with the formula ai + bi × (duri - 5), with ai representing the starting risk factor at 5 years, bi is the annual increase in risk beyond 5 years, and duri is the bond's duration in years.

These standardized methods are designed to be simple and transparent to implement and allow smaller or less sophisticated institutions to calculate capital requirements without the need to develop complex internal models. However, this simplicity comes at a cost. Because the methods depend entirely on external ratings,they effectively bind banks and insurers to the judgments of CRAs, which, as noted above, are predominantly the big three CRAs for emerging markets. Where a country or corporate entity is either unrated or poorly rated, high-risk weights must be applied by default. This approach disproportionately affects African sovereigns and corporates, many of which are either unrated or rated below investment grade. As of the time of this writing, out of fifty-four African states, thirty-four have been rated by major CRAs, and only two (Botswana and Mauritius) hold investment-grade ratings.[89] Under Table 1, for example, bonds issued by sovereigns with below-investment-grade ratings are automatically assigned a 100% risk weight, while those rated below B- receive a 150% risk weight.

As previously discussed, the poor ratings assigned to many African states are attributable to biases within the credit rating system. The standardized methods therefore embed these biases directly into the capital rules and make them a formal part of how regulatory capital is calculated. This, in turn, contributes materially to the elevated cost of borrowing, or "risk premium," faced by African entities.

It is true that the Basel Committee introduced a due diligence requirement in its 2017 Basel III reforms to reduce banks' mechanistic reliance on external credit ratings under the standardized approach.[90] This requirement mandates that banks undertake their own internal risk assessments when using external ratings to ensure that risk weights assigned to counterparties appropriately reflect the underlying risks.[91] It might therefore be argued that this obligation reduces banks' dependence on external ratings and thereby mitigates the institutionalized risk premium. However, the rule's design prevents it from achieving that outcome. After completing due diligence, banks must apply the more conservative risk weights of the two outcomes.[92] This means that the due diligence assessment can only justify a higher, but not a lower, risk weight than that implied by the external rating. As the Basel Committee explains,

[89] See UNDP, Sovereign Credit Ratings, supra note 16, at 6; Trading Economics, Credit Rating: Africa (June 2025).
[90] The Basel Framework, supra note 56, at paras. CRE20.4–CRE20.6. See also Basel III: Finalising Post-crisis Reforms, supra note 55, at paras. 4–6.
[91] Id.
[92] The Basel Framework, supra note 56, at para. CRE20.20.

> If the due diligence analysis reflects higher risk characteristics than that implied by the external rating bucket of the exposure (ie AAA to AA–; A+ to A– etc), the bank must assign a risk weight at least one bucket higher than the "base" risk weight determined by the published external rating. *Due diligence analysis must never result in the application of a lower risk weight than that determined by the external rating.*[93] *[Italics added for emphasis.]*

Therefore, the due diligence requirement does not mitigate the institutionalized risk premium. If anything, it risks reinforcing the premium by encouraging supervisors to impose additional capital charges during supervisory review, given the scope it creates for upward adjustments of risk weights.

II.3(b) The internal method

The standardized method is only one of two main methods available for calculating risk weights under Basel III and Solvency II. Regulated firms have the option of using internal methods, known as the Internal Ratings-Based (IRB) Approach under Basel III, and the Internal Model Approach (IMA) under Solvency II, which permit them to use their own risk assessment models to calculate capital requirements. Firms using these internal approaches are therefore not bound by external credit ratings when assigning risk weights.

However, in practice, the standardized method remains the most widely used.[94] Developing and maintaining internal models is highly complex and resource-intensive, and firms must undergo a rigorous approval process with national regulators to utilize such models. Additionally, recent regulatory developments have introduced constraints that reduce the appeal of the IRB approach. The Basel III reforms of 2017 introduced an "output floor" that ensures that the RWAs calculated using internal models cannot fall below 72.5% of what they would be under the standardized approach.[95] For example, suppose a bank calculates US$50 billion in RWAs using internal models, but under the standardized approach, the RWA would be US$100 billion. Without the floor, the bank would apply the capital requirement to the US$50 billion figure. However, with the full output floor in place (i.e., 72.5%), it must hold capital against at least US$72.5 billion. The BCBS notes that this measure "helps to maintain a level playing field between banks using internal models and those on the standardised approaches."[96]

[93] Id. See also Basel III: Finalising Post-crisis Reforms, supra note 55, at para. 39 (see also paras. 20 and 36).
[94] See, e.g., BCBS, High-level summary of Basel III reforms 2 (BIS, Dec. 2017), https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.
[95] To manage the potential impact of the floor, a transitional arrangement for phasing in the aggregate output floor was agreed to by the BCBS, in which a 65% output floor will apply from 2025, 70% from 2026, and 72.5% from 2027 onward. See Basel III: Finalising Post-crisis Reforms, supra note 55, at para. 9.
[96] High-level summary of Basel III reforms, supra note 94, at 11.

Yet, it also undermines the business case for using internal models—especially given their high development and maintenance costs—and may discourage even large banks from adopting or continuing to use them.[97] The measure effectively caps the potential capital benefits of internal models and links their outputs more closely to those of the standardized approach.

II.3(c) The African climate risk premium

New rules on the calculation of climate-related financial risks (hereafter, climate risks), under both the standardized method and internal method, also reinforce the African risk premium.

Climate change presents financial risks.[98] Major floods, storms, or wildfires can damage homes, buildings, roads, and other infrastructure. Businesses may also suffer significant losses. If the climate event is severe enough, it can impact the broader economy and potentially trigger a systemic shock. When such events occur, households, businesses, and governments may struggle to repay debts or meet their obligations to insurers. This gives rise to what is commonly known as physical (climate) risks for banks and insurers.[99] To address this, regulatory frameworks in many jurisdictions now require banks and insurers to incorporate physical climate risks into the calculation of risk weights for their exposures and to hold sufficient capital against exposures that are considered vulnerable to the risks.[100] In other words, the more a project is perceived to be exposed to physical climate risks, the more costly it becomes to obtain bank financing or insurance coverage for that project.

So, how are physical climate risks determined under the regulatory framework? Again, this is where the African risk premium begins to emerge. The risks are determined based on the location of a project, rather than its nature.[101]

[97] PwC, 'Basel IV': The Output Floor 2 (Jan. 2018), https://www.pwc.co.uk/financial-services/assets/pdf/hot-topic-basel-iv-the-output-floor.pdf.

[98] Bank of England, Transition in Thinking: The Impact of Climate Change on the UK Banking Sector (Sep. 2018); Network for Greening the Financial System, First Progress Report (NGFS, 2018); European Bank Authority, Report on Management and Supervision of ESG Risks (EBA, 2021).

[99] A second type of climate-related financial risk, known as transition risk, arises from the policy, legal, technological, and behavioral changes associated with the shift to a low-carbon economy. This study focuses on physical risks rather than transition risks. For a detailed discussion of transition risks and their drivers, see BCBS, Climate-related Risk Drivers and their Transmission Channels, p.7 et seq. (Apr. 2021).

[100] Supervisory guidance has been issued by regulators to enhance the capability of banks to measure and capture climate risks when calculating RWAs. See, e.g., Bank of England, Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks from Climate Change (Supervisory Statement 3/19, Apr. 2019); European Central Bank, Guide on Climate-Related and Environmental Risks: Supervisory Expectations Relating to Risk Management and Disclosure (Nov. 2020). See also BCBS, Principles for the Effective Management and Supervision of Climate-Related Financial Risks (June 15, 2022); Office of the Comptroller of the Currency, Principles for Climate-Related Financial Risk Management for Large Banks (Dec. 16, 2021).

[101] BCBS, supra note 99, at 11 et seq.

If a project is located in a region considered to be highly vulnerable to climate hazards, such as droughts, floods, storms, or wildfires, it will attract a higher regulatory capital charge even if the project is climate-friendly. Therefore, in this context, a renewable energy project situated in a flood-prone area will be considered riskier than a coal plant located in a safer location.[102] This makes it more costly to secure bank financing or insurance for such climate-vulnerable projects on the international market: financing or insuring them is potentially more capital-intensive for banks and insurers. This additional cost is often passed on to the borrower if the bank or insurer chooses to proceed with the transaction.

It is prudent to make the capital framework sensitive to climate risks. However, the problem is that Africa is disproportionately affected by how these risks are defined. The region as a whole is consistently regarded as exceptionally vulnerable to short-term climate variability and long-term climate change.[103] The Intergovernmental Panel on Climate Change (IPCC) notes, with high confidence, that Africa is expected to become the epicenter of climate vulnerability,[104] and the United Nations Environmental Programme (UNEP) has observed that Africa "stands out disproportionately as the most vulnerable region in the world."[105] The United Nations Framework Convention on Climate Change (UNFCCC) also considers that, owing to the region's dependence on rainfed farming, it is "an exposure and vulnerability 'hot spot' for climate variability and change impacts."[106] In addition to being considered the most vulnerable to climate change, the region is also widely regarded as the least climate-resilient globally.[107] As a result, African states and businesses are more likely to face a "climate risk premium" when seeking funding from international banks or insurance coverage from global insurers. These conditions, alongside those discussed above regarding the standardized approach, make it significantly more expensive and challenging to finance or insure projects in the region, even when those projects are aligned with climate goals.

[102] The reason for this outcome is that regulators believe that the capital framework is primarily risk-based and should not be used as a tool to advance government climate policies. See, e.g., Bank of England, Climate-related Financial Risk Management and the Role of Capital Requirements 27 et seq. (Climate Change Adaptation Report 2021); European Banking Authority, Report on the Role of Environmental and Social Risks in the Prudential Framework 22 et seq., Oct. 2023, EBA/REP/2023/34.
[103] Christopher Trisos et al., Africa, in Climate Change 2022: Impacts, Adaptation and Vulnerability: Contribution of Working Group II to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change chap. 9 (HO Pörtner et al. eds., Cambridge University Press, 2022). See also Lotsmart Fonjong, Frank Matose & David A. Sonnenfeld, Climate Change in Africa: Impacts, Adaptation, and Policy Responses, 89 Glob. Envtl. Change 1, 2 et seq. (article 102912, 2024), https://doi.org/10.1016/j.gloenvcha.2024.102912.
[104] Trisos et al., supra note 103, at 1294.
[105] UNEP, Responding to Climate Change, UNEP (Feb. 2024), https://www.unep.org/regions/africa/regional-initiatives/responding-climate-change.
[106] UNFCCC, Climate Change is an Increasing Threat to Africa (Oct. 2020), https://unfccc.int/news/climate-change-is-an-increasing-threat-to-africa.
[107] See, e.g., AfDB, African Economic Outlook 2022, p. 5 et seq. (May 25, 2022).

According to the AfDB, “to close Africa’s climate financing gap by 2030, approximately $213.4 billion will need to be mobilised annually from the private sector, to complement constrained public resources.”[108] Yet, the current regulatory framework of international financial markets actively undermines this objective by embedding both an African risk premium and a climate risk premium into capital requirements for banks and insurers, which effectively stifles the flow of finance into the region.

Part III. AFRICAN CREDIT RATING AGENCY

III.1 Initial comments:

So far, this study has examined the two drivers of the African risk premium that are generally known in current literature. The first arises from CRAs’ and investors’ biases or perceptions that Africa is risk-prone. This is referred to herein as the “perceived African risk premium.” It is perceived in the sense that the premium is not justified when assessed against the quantitative and qualitative indicators of the creditworthiness of the countries concerned. The second driver, by contrast, is attributed by some commentators to structural weaknesses within the region (i.e., qualitative indicators of creditworthiness). This form of premium is therefore considered justified and is referred to here as the “real African risk premium.” These two drivers were the focus of Part I.

Part II introduced a new third driver, which arises from the requirements of international regulatory frameworks. I refer to this as the “institutionalized African risk premium.” This type of premium can manifest in various forms and across multiple regulatory regimes. In this study, it is examined specifically in the context of regulatory capital requirements applicable to internationally active banks and insurers. These institutions are dominant players in the Eurobond market, and they therefore provide a suitable focus for analysis. It was noted in Part II.3 that the institutionalized risk premium arises primarily in two ways: (i) as a result of the reliance of Basel III’s and Solvency II’s standardized method on external CRA ratings; and (ii) as a result of the risk-based approach used in calculating climate-related financial risks.

Building on the framework developed in these earlier sections, this part assesses the extent to which AfCRA is likely to address the premium problem and offers recommendations for reform.

[108] AfDB, African Economic Outlook 2023, p. 61 et seq. (May 24, 2023).

III.2 An overview of AfCRA:

Before continuing, it is important to note that most available publications on AfCRA at the time of this writing take the form of press releases, news reports, and high-level statements from the leadership of African institutions. Accordingly, much of the material cited in this section reflects that trend. However, care has been taken to ensure that sources referenced are authoritative and reliable.

AfCRA is an African Union (AU) initiative and has been under development since around 2019.[109] The AU makes clear that AfCRA's objective "is not to compete with or replace" the big three CRAs.[110] Rather, it will "complement" them by providing an alternative perspective that is more accurate and sensitive to the specific context of African economies.[111] Further insights about the new agency were provided by Dr. Misheck Mutize, African Peer Review Mechanism (APRM)[112] Lead Credit Rating Expert, who noted that the agency "is not being established to issue favourable ratings for African entities."[113] He added that "[o]ur priority is to build a credible, independent, and sustainable institution that plays a vital role in developing domestic debt markets and rebalancing Africa's position within the evolving global financial architecture."[114] As such, the agency is focused exclusively on providing ratings for African states and institutions, with the primary aim of deepening domestic capital markets in the region. AfCRA is set to launch in September 2025, with its first ratings expected between late 2025 and early 2026.[115]

In terms of its ownership and governance, AfCRA is intended to be privately owned, self-governed, and financially independent.[116] This structure is essential if the agency is to be seen as credible and objective by financial actors.

[109] It was officially discussed in 2019 in the Third African Union Specialized Technical Committee (STC) on Finance, Monetary Affairs, Economic Planning and Integration meeting, in which the committee declared the importance of the new agency and requested the African Union's African Peer Review Mechanism (APRM) and the African Union Commission to carry out a feasibility study on its creation. For a copy of the declaration, see African Union, The 3rd STC on Finance, Monetary Affairs, Economic Planning and Integration (2019), https://au.int/sites/default/files/documents/36961-doc-declaration_final_e.pdf.

[110] Press Release, African Union, African Leaders Convene on Establishment of Homegrown Solution, The Africa Credit Rating Agency, sec. 6, (Feb. 7, 2025), https://au.int/sites/default/files/pressreleases/44406-pr-AFRICA_CREDIT_RATING_PR.pdf.

[111] Id., secs. 6 and 7.

[112] APRM is an organization within the African Union (AU) that focuses on promoting good governance and accountability amongst member states.

[113] UNECA, Experts Convene in Washington to Advance Dialogue on an African-led Credit Rating Ecosystem (May 1, 2025),https://www.uneca.org/stories/experts-convene-in-washington-to-advance-dialogue-on-an-african-led-credit-rating-ecosystem.

[114] Id.

[115] EcoFin Agency, African Credit Rating Agency to Launch by September 2025 (June 10, 2025), https://www.mfw4a.org/news/african-credit-rating-agency-launch-september-2025. The launch date was initially set for June 2025 but has been delayed to allow for further consultations and, possibly, the recruitment of senior agency officials. See African Union, supranote 110, at sec. 9.

[116] Cash & Khan, supra note 4, at 22.

If African governments— which will also be the subjects of AfCRA's ratings—were to hold ownership or control over the agency, its independence would be compromised. Yet, despite clarifications that AfCRA will operate as a privately driven institution, some doubts persist. Questions remain about the extent to which the agency can remain free from indirect government influence, whether through political pressure, control over data sources, or subtle expectations regarding rating outcomes. These fears are relevant, given that the agency originated as an initiative of African states through the AU, and its foundational mandates were shaped by them.[117]

Furthermore, while the AU's APRM is described as merely "a supporter and strategic partner in AfCRA's development and operations," the body is also expected to "provide governance insights, institutional frameworks, and technical expertise that inform [AfCRA's] methodologies," and to ensure that the agency "aligns with broader African Union objectives of sustainable development and integration."[118] It is certainly possible for the APRM to provide this kind of support while preserving AfCRA's independence. However, this will require great care. The agency must not be beholden to the instructions of any political body. The APRM's role should remain strictly advisory. More broadly, AfCRA's independence must be rooted across its entire governance system—from its ownership structure to its constitutional framework, board composition, senior management, decision-making processes, operational systems, and finances. Only with such a structure in place can AfCRA gain credibility and the trust of investors and other stakeholders within and outside the region. Two further-related points are worth making here.

Investors are to credit rating agencies what readers are to authors. As readers decide which books become bestsellers, so also do investors decide which rating agency is relevant. If target investors assign more weight to Agency A than Agency B, a bond issuer will more likely choose to have its bonds rated by Agency A, even if Agency B is cheaper or more favorable. Accordingly, this is a sector in which investor trust is paramount, and it will be essential for the new agency to safeguard and cultivate this trust with the utmost diligence. Another key point is that transparency in the methodologies used to determine ratings, as well as the recruitment of experienced and highly qualified staff, will be crucial in building trust and, in turn, ensuring the agency's success.

Beyond the issues of credibility and trust, there is the question of how effective AfCRA will be in addressing the African risk premium. To answer this, it is helpful to look at the different types of risk premium separately: the perceived, the real, and the institutionalized components.

[117] Some of these mandates are briefly set out in African Union, supra note 110.
[118] African Union, supra note 110, at sec. 4.

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III.3 AfCRA and the perceived African risk premium:

This part of the premium is driven by the assumptions and biases of CRAs and investors. In explaining the rationale for AfCRA, the AU has stated that it "was established to address concerns over perceived biases, inaccuracies, and high costs associated with international credit rating agencies when assessing African countries."[119] AfCRA is therefore primarily intended to address the perceived risk premium. Being based in Africa and staffed with experts familiar with the region, AfCRA is well-positioned to provide more accurate and locally informed assessments of creditworthiness. However, as noted earlier, building trust within the international financial community will be essential for AfCRA's ratings to be taken seriously. Achieving this trust will not be easy and will require time and sustained effort.

Reports suggest that the new agency will focus primarily on bonds issued in local currencies.[120] While the AU and APRM have not officially confirmed this claim, as of the time of this writing, it aligns with their objective of using the agency to support the development of domestic capital markets. The continent faces a striking paradox: while it struggles with an immense funding gap to meet its climate and development needs, around US$2.3 trillion of local private capital—held by banks, pension funds, and insurers—remains underutilized partly due to shallow capital markets.[121]

[119] Id., sec. 2. The quotation may suggest that the agency is already operational. However, as noted earlier regarding the launch date, this is not the case.
[120] See e.g., EcoFin, supra note 115; Nairametrics, Africa's Credit Rating Agency to Launch in September as Alternative to Fitch, Moody's (June 9, 2025), https://nairametrics.com/2025/06/09/africas-credit-rating-agency-to-launch-in-september-as-alternative-to-fitch-moodys/.
[121] FSD Africa, Mobilising Domestic Capital to Drive Climate-Positive Growth, FSD Africa (June 5, 2024), https://fsdafrica.org/mobilising-domestic-capital-to-drive-climate-positive-growth/. For a more detailed analysis, see Systemiq, et al., Mobilising Domestic Capital to Drive Climate-Positive Growth: Action Agenda 11 et seq. (June 2024), https://static1.squarespace.com/static/5acdc066c258b4bd2d15050b/t/6662f35a9f4e88581ccc8bf8/1717760874071/Action+Agenda+-+Mobilising+Domest+Capital+to+Drive+Climate-Positive+Growth+vDigital.pdf.

A deep domestic capital market is also viewed by the big three CRAs as a “credit strength” that can support more favorable ratings.[122] Therefore, there is merit in focusing the agency’s efforts on supporting domestic bond markets. Operationally, starting with local currency bonds is also a pragmatic choice. It will allow the agency time to build credible methodologies and operational systems that are recognized and respected internationally without the immediate pressure of competing with the big three CRAs on the global stage.

However, the agency cannot limit its operations to domestic bond markets if it truly intends to address the perceived risk premium. Over time, it will be necessary for it to extend its coverage to African Eurobonds[123] where, as seen in Part I, the premium is most pronounced. As noted earlier, the funding needs of the continent are enormous, [124] and these cannot be met solely through domestic capital markets. International capital markets will continue to play a vital role in financing the region and are likely to remain in demand by its countries and institutions for the foreseeable future.[125]

In addition to the ratings function, AfCRA is well-placed to develop a reliable and comprehensive regional database covering quantitative and qualitative factors that CRAs and investors typically use to assess creditworthiness. Quantitative factors would include indicators related to economic and fiscal performance, while qualitative factors would include institutional strength, governance quality, and the political stability of a relevant sovereign.[126] This database would be accessible to the public, including investors and CRAs, either free of charge or on a fee basis. It would complement existing databases, such as those provided by the World Bank and IMF, and could offer informed alternative perspectives where appropriate. Crucially, the database would help fill important data gaps that currently exist. A challenge facing the continent, and a contributor to the African risk premium, is a lack of reliable, granular data on some indicators that influence assessments of creditworthiness, particularly qualitative ones. This absence has often created room for assumptions, generalizations, and biases by external CRAs and investors. Improved availability of, and access to, such data could enable these actors to conduct more informed credit analyses of institutions in the region and potentially lead to fairer and more accurate assessments.

[122] Moody’s, Rating Methodology: Sovereigns 18, 42 (June 5, 2025).
[123] In this context, “African Eurobonds” refers specifically to bonds issued by African countries in foreign currencies—that is, currencies other than those of any African nation, most commonly the US dollar and the euro. This usage differs slightly from the broader definition of Eurobonds, which encompasses all bonds issued in a currency different from that of the issuer’s domestic currency.
[124] The continent faces an estimated US$1.3 trillion annual shortfall in the finance required to achieve its basic Sustainable Development Goals (SDGs) by 2030. See UNDP, Sustainable Finance Report: Africa, supra note 1, at 21.
[125] In the context of the investment need for climate action, a new report from Systemiq’s Blended Finance Taskforce and FSD Africa estimates that “[m]obilising a growing pool of domestic capital could
[only] halve the existing climate investment gap.” Systemiq, et al., supra note 121, at 8 et seq.
[126] See e.g., Moody’s, supra note 122, Exhibit 4, p. 8 et seq. See also Patrycja Klusak, Yurtsev Uymaz & Rasha Alsakka, Politicians’ Connections and Sovereign Credit Ratings, 94 J. Int’l Fin. Mkts., Insts. & Money 21 (2024), which suggests that in addition to the quantitative and qualitative components, the sovereign rating process includes a “subjective part” that is driven by professional connections between a country’s politicians (finance ministers) and top executives of credit rating agencies.

This, in turn, could help reduce the perceived premium at the grading stage and lead to more accurate yield calculations by investors at the post-grading stage.[127]

Professor Carlos Lopes, former Executive Secretary of the United Nations Economic Commission for Africa, once said that "the data that informs the narrative dictates the story."[128] AfCRA will do well to present credible, homegrown data that adds balance and context to how African creditworthiness is narrated and understood.

III.4 AfCRA and the real and institutionalized African risk premium:

While AfCRA may help address the perceived premium, it will do little to mitigate the real and institutionalized components.

The real risk premium arises from structural weaknesses in parts of the region. These are not perceived or imagined risks, but real (or actual) ones that can affect creditworthiness. Indicators of such risks typically fall within the qualitative assessment factors. Using Moody's latest sovereign rating methodology indicators, these would include factors such as (i) the quality of institutions—like the judiciary, civil society, and legislature; (ii) the effectiveness of policies—such as monetary, fiscal, and macroeconomic policies; (iii) political risks; and (iv) the quality of domestic banking and capital markets.[129] If an African state has any of these issues, AfCRA cannot fix them. AfCRA cannot change the quality of public institutions or transform the effectiveness of monetary and fiscal policies. What it can do is advise sovereigns on areas that require improvement and provide assessments that reflect progress when it is made. But to truly reduce the real African risk premium, African states themselves must take the lead in addressing the structural challenges affecting them.

The discussion now turns to the institutionalized African risk premium. This premium is built into global financial rules and must be adopted by financial institutions subject to the rules. The premium is discussed in this study from the context of the regulatory capital requirements applicable to banks and insurers, in which it was noted in Part II.3 that the premium arises primarily in two ways: (i) as a result of the reliance of Basel III's and Solvency II's standardized method on external CRA ratings; and (ii) as a result of the risk-based approach used in calculating climate-related financial risks. The following paragraphs discuss the extent to which AfCRA can address both aspects of the premium.

Regarding the premium arising from (i) above, a fairer rating provided by the new agency will not automatically reduce the capital charges faced by the region.

[127] See Part I supra for a discussion of how the risk premium arises at these stages.
[128] UNECA, Embrace Data, Counter Stereotypes on Africa (Nov. 13, 2015), https://archive.uneca.org/stories/embrace-data-counter-stereotypes-africa-says-carlos-lopes-media-leaders.
[129] Moody's, supra note 122, Exhibit 4, at 8 et seq.

For a rating to influence capital charges, it must be used by the relevant bank or insurer. These firms have discretion over which rating agency to use, and even then, only agencies that meet strict eligibility requirements can be recognized.[130] For instance, to be eligible under Basel III, a rating agency must meet the criteria in paragraph CRE21.2, which include objectivity, political and economic independence, transparency of the rating methodologies used, strong technical capacity, and credibility. Such an agency will also need to be registered and certified in the jurisdiction in which the bank or insurer operates. These rules have been adopted in national and supranational legal frameworks.[131]

All of this means that for AfCRA to be considered by a bank or insurer in the first place, it must meet the eligibility requirements and be certified in the relevant jurisdiction. These conditions reinforce the earlier point that the agency must be seen as credible and trusted.[132] Even then, its ratings must be nominated by the bank or insurer to be used for determining regulatory risk weights.

If AfCRA remains focused within Africa and is certified as meeting the eligibility requirements in countries across the region, its ratings are expected to be more readily recognized and nominated by banks and insurers operating in the region, given its status as a regional credit rating agency. However, as noted above, the African risk premium is most prominent in transactions involving African entities and international financial institutions—that is, internationally active banks and insurers in the context of the regulatory capital framework. To have any meaningful impact on the premium, AfCRA will need to extend its operations beyond the region and require the relevant banks and insurers to nominate its ratings. As noted in Part II.3 above, these firms often default to the big three CRAs—especially when dealing with developing economies like those in Africa, where data limitations make it difficult for smaller agencies to gain a foothold. However, a credible and respected AfCRA would be in a stronger position to compete with the big three, given its regional focus and contextual insight. But the agency will need some time to build the credibility and trust required to reach that point.

We now turn to the institutionalized premium that arises from how climate risks are assessed under Basel III and Solvency II [see the discussion in Part II.3(c)]. This aspect of the premium falls outside the remit of AfCRA. The capital rules in these frameworks assess physical climate risks primarily based on the location of a project rather than the nature of the project. These rules need to be followed by all financial institutions involved in risk assessments, including CRAs. Therefore, AfCRA will be bound by the rules, and it has no formal power to shape them. The responsibility of addressing this aspect of the premium falls to African states themselves to advocate for reforms that align the capital frameworks with Africa's financial needs.

[130] The Basel Framework, supra note 56, at para. CRE 21.1; Solvency II Regulation, supra note 64, at art. 4.
[131] For example, these requirements are prescribed in the EU, art. 135 of the Regulation (EU) No. 575/2013 (CRR I) and Regulation (EC) No. 1060/2009 on credit rating agencies.
[132] See the discussion supra in Part III.2.

One possible solution is to introduce a capital reduction factor in calculating risk weights for climate-friendly loans, which could lower the amount of capital that banks are required to hold against such loans flowing into Africa. The EU's SME and infrastructure supporting factors provide helpful examples of how capital frameworks can be adjusted to promote specific policy goals without compromising financial stability.[133] The SME supporting factor allows banks to reduce risk weights by 15% on eligible exposures to small and medium-sized enterprises.[134] Similarly, the infrastructure supporting factor allows banks to lower risk weights by 25% for qualifying exposures on infrastructure projects that meet strict quality and risk criteria.[135] These supporting factors are policy innovations introduced by the EU to promote lending to sectors seen as critical for economic growth.

In the same way, a climate supporting factor could encourage banks and insurers to increase or facilitate financing for high-quality, climate-friendly projects in Africa. This solution acknowledges the negative impact of the climate risk premium on the flow of finance into the continent and adjusts capital frameworks to promote finance in the region while preserving financial stability. Achieving this adjustment will require African states and their partners to make a strong, evidence-based case, either within global standard-setting bodies like the Basel Committee and the IAIS, or directly to national regulators and governments in regions where internationally active banks and insurers are typically headquartered. The goal will be to secure the inclusion of a climate supporting factor in capital frameworks.

CONCLUSION

This study has sought to examine the different ways in which the African risk premium manifests, with the aim of developing a clearer framework to assess the effectiveness of existing solutions and to help chart new pathways for addressing the premium. In doing so, the study makes three important contributions.

First, it analyzes the two drivers of the premium that are recognized in current literature. These are the perceived and the real African risk premiums. This analysis sheds light on the two stages at which the perceived risk premium arises—namely, the grading stage and the post-grading stage. Furthermore, it questions the prevailing view that the real risk premium is justified by structural weaknesses in the region and challenges the corresponding solution, which places the responsibility for addressing the premium solely on African states' domestic reforms.

[133] For the SME supporting factor, see art. 501 CRR I, supra note 131. For the infrastructure supporting factor, see art. 501a of Regulation (EU) 2019/876 (CRR II).
[134] See art. 501 CRR I, supra note 131. Also, under the Basel III framework, an 85% risk weight applies to unrated exposures to corporate SMEs (instead of the standard 100%), and a 75% risk weight applies in certain circumstances. See The Basel Framework, supra note 56, at paras. CRE20.47, CRE20.65(1), and CRE20.65(3).
[135] Art. 501a, CRR II, supra note 133.

Second, the study identifies a third driver of the African risk premium that has received very little attention in the literature. This driver arises from the requirements of international regulatory frameworks and is referred to in this study as the institutionalized African risk premium. It is described as “institutionalized” because it is embedded in the rules and standards that govern the global financial system. It is therefore not a matter of what the market thinks or perceives about the continent but what it is compelled to do.
This is a significant contribution. Perceived risk premiums are merely symptoms of a deeper problem. The root cause lies in the financial principles and regulatory structures that financial institutions and credit rating agencies are required to follow. Until these institutionalized risk premiums are addressed, the African risk premium will persist, and climate and development finance costs in the region, as well as the wider cost of external debt finance, will remain prohibitively high.

The institutionalized premium can manifest in various forms and across multiple regulatory regimes. In this study, it is examined specifically in the context of regulatory capital requirements applicable to internationally active banks and insurers. These institutions are dominant players in the Eurobond market and therefore provide a suitable focus for analysis.

Finally, building on the clear framework established by the preceding contributions, this study assesses the effectiveness of the new African Credit Rating Agency (AfCRA), a key solution to the risk premium problem proposed by the African Union, and offers recommendations for reform. The paper argues that AfCRA can play a direct role in addressing the perceived African risk premium, although it has a limited scope to address the real and institutionalized components. Addressing these last two forms of the premium requires interventions on various levels.

In the case of the institutionalized premium, African states and institutions must engage with Western institutions that predominantly shape global rulemaking, and they must specifically advocate for reforms that address structural imbalances in the regulatory system that disproportionately penalize them. A solution proposed in this study is the use of a climate supporting factor when calculating how risk weights are attached to investments in Africa. This solution recognizes the negative impact of the climate risk premium on financial flows into the continent and proposes an adjustment to the capital charges under Basel III and Solvency II to promote sustainable finance in Africa while preserving financial stability.

The need for this study has become even more pressing given the changing composition of Africa’s external debt. Over the past two decades, African states have increasingly turned to international bond markets as a key source of finance. This shift became especially pronounced following the 2008 global financial crisis. For example, African sovereign bond holdings surged from US$22.6 billion in 2009 to US$140 billion by 2023, an increase of more than sixfold.[136] Meanwhile, bilateral debt in the region grew at a slower pace, nearly doubling to US$103.6 billion during the same period.[137]

This shift in external debt sources has also led to significantly higher borrowing costs for the region. Between 2013 and 2019, African-issued 10-year Eurobonds carried coupon rates ranging from 4.8% to 10.8%, notably higher than the rates on bilateral or multilateral loans, which were often below 2%.[138]

These elevated yields mean international bonds represent a disproportionately large share of total debt-servicing costs in the region.[139] The region's external debt service grew from US$13.4 billion in 2000 to 30.9 billion in 2013, reaching a record high of US$81 billion in 2022,[140] closely mirroring the rise in sovereign bond issuances across the region. In 2020, low- and middle-income countries, including those in sub-Saharan Africa, allocated 63.2% of their total interest payments to international bonds, compared to just 9.8% for bilateral obligations.[141] This growing reliance on bond markets and the associated costs has serious fiscal implications. Sub-Saharan Africa's public debt rose from around 32% of GDP to 61% between 2012 and 2024,[142] with debt servicing becoming the most rapidly increasing budgetary item. According to Afreximbank, the ratio of interest payments to total government revenue rose from 6.8% in 2008 to 27.5% in 2024.[143] This, in turn, has reduced the resources available to finance the region's development and climate needs.

With this significant shift in the composition of the region's external debt toward international bond markets and the associated costs, it becomes necessary to scrutinize the decisions of the "gatekeepers" of global capital markets and examine the regulatory frameworks that govern these markets. This scrutiny is essential for understanding how these actors and frameworks contribute to the African risk premium and how the premium might be effectively addressed.

[136] World Bank, International Debt Statistics: Sub-Saharan Africa (2024) https://datatopics.worldbank.org/debt/ids/regionanalytical/SSA. See also African Sovereign Debt Justice Network, One Hundred and Thirteenth Sovereign Debt News Update: African Countries and Eurobonds: An Avalanche of Buybacks in 2024, Afronomicslaw.org(Mar. 20, 2024), https://www.afronomicslaw.org/index.php/category/african-sovereign-debt-justice-network-afsdjn/one-hundred-and-thirteenth-sovereign-debt, which puts the figure at US$115 billion as of 2019.
[137] World Bank, supra note 136.
[138] See, e.g., Ivory Coast Turns to World Bank to Replace Costly Debt, Fin. Times (Dec. 2024).
[139] On the reasons for the surge into the international financial market, see Tang Xiaoyang, The Trap of Financial Capital: The Impact of International Bonds on the Debt Sustainability of Developing Countries 7 (Aug. 2022), which identifies factors such as flexibility, lack of conditionality, full discretion over the use of funds, and the declining availability of traditional financing sources. Regarding the latter, see further: African Sovereign Debt Justice Network, Eighty-First Sovereign Debt News Update: The Big Funding Squeeze: Analyzing the IMF's Austerity Plans for Africa's Deteriorating Debt Situation," Afronomicslaw.org. (May 2, 2023), https://www.afronomicslaw.org/category/african-sovereign-debt-justice-network-afsdjn/eighty-first-sovereign-debt-news-update-big.
[140] This figure encompasses both principal repayments and interest payments on public and publicly guaranteed external debt. SeeWorld Bank, supra note 126.
[141] Xiaoyang, supra note 139, at 1.
[142] IMF, Regional Economic Outlook: Sub-Saharan Africa 21 (Apr. 2025), https://www.imf.org/en/Publications/REO/SSA/Issues/2025/04/25/regional-economic-outlook-for-sub-saharan-africa-april-2025#notes.
[143] Afreximbank, supra note 3, at 8–9. See also UNCTAD, A World of Debt Report 2024: A Growing Burden to Global Prosperity 16 (UNCTAD 2024), https://unctad.org/system/files/official-document/osgttinf2024d1_en.pdf.