

Extract from the report:

Building new foundations: Reimagining the International Financial Architecture

Views and proposals from civil society

Affordable finance: How to cancel the hidden expenses of risk premiums for states and private actors

By Oliver Pahnecke
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With contributions from



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The global debt burden has reached unprecedented levels.¹ Over 20 years, global public debt has quadrupled, while global Gross Domestic Product (GDP) only tripled.² In January 2024, six developing countries had country risk premiums above 20 percent;³ 39 percent of developing countries make net interest rate payments exceeding 10 percent of total public revenue. Only 14.8 percent of these countries have an investment-grade credit rating.⁴ Global debt has been unsustainable for decades but what if there was one mechanism in the International Financial Architecture that is largely responsible for this lack of debt sustainability? What if this mechanism could be corrected to make – to a great extent – the international financial architecture more resilient and lending more affordable? For 30 years lending uses weighted risk, adding risk premiums to the interest rates of loans. In this system, the risk premium can replace collateral and protects the lender’s principal.⁵ If the risk premium were legally treated as a collateral *sui generis*, loans could become significantly cheaper because risk premiums would have to be returned after full repayment, or adjusted over time, in accordance with the real default risk. This article analyses the cost of today’s risk premium system for States and their citizens’ human rights.

Risk premiums in the International Financial Architecture

Before we can analyse the impact of risk premiums on sovereign finance and human rights, we need to understand how risk premiums work and how they are threatening the current International Financial Architecture (IFA).

1) How risk premiums work

In 1974, central bank governors founded the Basel Committee “to enhance financial stability by improv-

ing the quality of banking supervision worldwide”.⁶ Its work led to the introduction of weighted risk in the 1990s to make risk internationally comparable.⁷ Weighted interest rates consist of the prime rate – the basic interest rate available for short-term loans to riskless clients, which is the price for the loan – and a risk premium added on top that reflects the borrower’s default risk. In cases of poor collateral, the risk premiums in interest rates will be high, while they will be low in cases of good collateral. This shows risk premiums and collateral can be exchanged, meaning they basically have the same function.⁸ This argument is supported by the fact that these interest rates,

1 Tiftik/Mahmood/Aycock (2024).

2 UN Global Crisis Response Group (2023), p. 5.

3 Damodaran (2024).

4 UNDP (2024).

5 Pahnecke/Bohoslavsky (2021).

6 Bank for International Settlements, History of the Basel Committee (<https://www.bis.org/bcbs/history.htm>).

7 Ibid.

8 Pahnecke/Bohoslavsky (2021), p. 18.

which were increased by risk premiums, accelerate the repayment of the principal because then the compounding takes place at a higher rate than before.⁹ Accelerated repayments protect the lender's principal in absence of (good) collateral. Since risk premiums can be replaced by conventional collateral, and because they protect the lender's principal, the risk premium has to be understood as a collateral *sui generis*.¹⁰ Accordingly, risk premiums remain the property of borrowers and should either be returned at the end of the loan contract or adjusted over time in accordance with the real risk, just like any other collateral. That way a risky borrower would end up paying the same price for the loan as a low-risk borrower that has a low risk premium due to collateral.

However, current financial practice regards risk premiums chiefly as the price for risk, but also as an insurance or as a means for cross-financing risk among different borrowers. The risk premium cannot be an insurance premium, though, because there is no insurer involved and the finance industry uses other means to hedge risk. According to the Federal Reserve, the risk premium is also not used to cross-finance the risk between borrowers, because this would undermine market discipline on the individual borrower.¹¹ Most importantly, different prices for the same product based on the clients' financial status and without justification would be discriminatory. Discriminatory pricing would collide with anti-discrimination law, with deep roots in both national constitutional law and international human rights law.¹²

Different prices can be justified only at the beginning of a loan contract since the riskier client will repay the principal to the lender with the help of the risk premium at an earlier point than without. But over time the default risk diminishes with each instalment until the full principal is paid by the borrower. In this moment, the default risk related to the lender's investment – the principal – drops to zero. From now on, the

different prices are not justified any longer. To avoid discriminatory pricing, the risk premium could therefore be repaid at the end of the loan contract. Preferably, however, the risk premium should be adjusted over time, in accordance with the real default risk until all clients end up with paying the same price.¹³

It follows that the actual function of the risk premium is indeed the protection of the lender's investment, the principal. As a means to offset risk, it serves as a collateral *sui generis*. Consequently, the risk premium cannot be a price for risk, either.

What looked like – and still is – a practical and smart tool to make loans available for clients with little or no collateral turned into a faultline in the IFA because the Basel Accords confuse price, collateral and property.

Risk premiums as collateral *sui generis* remain the property of the borrowers, as long as there is no default, because collateral is the property that a borrower puts up as security for the lender's payment claim against them.

Interest rates, on the other hand, are the market-driven price for the loan and therefore are not yet the property of the lender. This means that interest rates cannot enjoy the same protection as property. However, because of the Basel Accords, interest rates and risk premiums are treated as if they were the property of the lender, although the only property of the lender that exists in the context of lending is the principal. Only the principal has already been legally acquired and therefore it is protected by constitutions and international treaties as property.

This current practice affects anybody that is not a low-risk prime rate client, and therefore, without justification, targets a large group of people charac-

9 Ibid p. 19-20.

10 "Sui generis" is a Latin term used in law to describe something "unique" or "of its own kind".

11 Ibid p. 16.

12 Ibid p. 23ff and 31ff.

13 Ibid p. 23-29.

terized by their social status and their financial background.¹⁴

2) Why risk premiums pose a threat to the IFA

Risk premiums would constitute a threat to the current IFA if they increased the counterparty default risk significantly at an international level. If the risk premium caused such a faultline in the IFA, it would counteract the aims of Basel I, which would then need to be amended.

If the risk premium is a replacement for collateral, it belongs to the borrower. From this, it follows that the lender has no legal claim to keep the risk premium once the borrower has fulfilled their contractual duties, which would mean returning the principal and paying the interest. In practice however, the risk premiums are accounted for as if they were the property of the lender. This confusion has far-reaching implications.

Firstly, the price discovery for risk does not work because the natural price for risk would have to be lower if the risk premium had to be returned or adjusted in accordance with the real risk.

Just as problematic for the economy is the silent absorption of the risk premiums by the lenders, although this money should be returned to the borrowers. This mechanism works like an expropriation of all borrowers who are riskier than prime rate clients, based on the wrong assumption that weighted interest rates are a price for risk. If lenders were to keep conventional collateral, such as real estate, which is offered instead of a risk premium, the disproportionality of this flawed practice would become more obvious.

A third problem is derived from paragraph 61 of the Basel Accord III. Based on this, lenders are required to make adjustments in their management of counter-

party risk at least every three months, or more frequently if conditions require it.¹⁵ In practice this means that lenders will have fewer expenses for risk management if their risk decreases, but they do not pass these savings on to their clients since borrowers are treated as if they posed the same risk over the whole duration of the contract, although in fact the risk decreases over time with each payment.¹⁶ This also means that lenders are already obliged to collect the data that is necessary to adjust the risk premium in accordance with the real risk to prevent discriminatory pricing. However, the Basel Accords neither demand that lenders pass on the savings that are based on reduced risk management expenses, nor do they require an adjustment of the risk premiums. Instead of funnelling risk premiums and cost savings from clients to lenders, the Basel Accords should be adjusted to reflect the definition of property. This would limit legal protection to the principal and distinguish price from property and collateral.¹⁷

Another grave problem appears to be that conventional collateral depreciates because of wear and tear. Risk premiums, on the other hand, grow exponentially due to compound interest.¹⁸ This means the risk premium is more attractive for a lender since it grows over time, compared to conventional collateral, which loses value. Additionally, riskier clients are forced to pay far higher risk premiums than prime rate clients, who can offer excellent collateral and therefore only pay for minimum risk. Because of this, the motto seems to have become “the riskier, the better” for some lenders.

Imprudent lending is also facilitated by the fact that, in boom times, it is easy to sell claims against lenders that might face distress. However, in times of crises, the advantage of high-yielding risk premiums turns into the opposite, when everybody is trying to sell the loans of distressed borrowers. This results in plummeting prices and lenders will expect bailouts by the State, especially once they pose a high risk to the

14 For the legal aspects of discrimination based on property, see Pahnecke/Bohoslavsky (2021), pp. 31–42.

15 Basel Committee on Banking Supervision (2011), II. A. 1. 98. §§ 25(i) & 61, pp. 30–31.

16 Pahnecke/Bohoslavsky (2021), p. 31.

17 Ibid p. 43.

18 Ibid p. 20.

economy. Mario Draghi wrote that such “distorted incentive structures that induce borrowers and/or lenders to engage in risky financial behaviour, or inadequately monitor the risks they assume, in the expectation that they will be insulated from the adverse consequences of their activities by the public authorities” are a “moral hazard”.¹⁹

If lenders can count on help in the form of bailouts, bail-ins or other measures – instead of facing accountability through market discipline – there is no limit to risk. The larger the default risk that one or several lenders face, the bigger the risk for a collapse of the entire IFA. With this in mind, Mario Draghi, Jürgen Stark, Mervyn Allister King and Larry Summers have demanded that “expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector” are discouraged.²⁰

Today’s price-for-risk-practice also increases the risk in the financial system and for the lender in another way: Prime rate clients pay only the basic interest rate and almost no additional price for risk but provide excellent conventional collateral. Such borrowers only put up something valuable to secure the lender’s claim in case of a default and therefore the total risk in the financial system does not increase. In contrast, risky borrowers pay the basic interest rate and the risk premium on top. But if a client already has fewer funds for economic activity, increasing payment obligations will increase the counterparty risk for the lender because the borrowers’ default becomes more likely the more they have to pay. The higher the financial burden, the higher the default risk. Depending on how many lenders will default, the risk can spread within the financial system.

It becomes clear that risk-weighted interest rates place a higher burden on riskier clients than riskless clients by accelerating the repayment of the principal. While this acceleration is necessary to protect the lender’s principal, it gives the riskless clients a cost advantage because they can use the principal for a

longer period of time. Should the riskless and the risky borrower compete in the same business, the riskier borrower might have to ask for higher prices per unit to pay the higher redemption payments. In turn, the principal remains with the riskless client for a longer period of time due to lower redemption payments, making lower prices possible.

The fact that the Basel Accords treat principal, interest and risk premium as if they were all the property of the lender establishes a mechanism that increases counterparty risk, distorts price discovery and expropriates those of lesser economic capacity. This mechanism also affects the market negatively, as lenders are misled into imprudent risky lending for higher yields, while betting on bailouts and thus causing moral hazard. However, the opposite is likely to happen if the risk premiums were treated as collateral *sui generis* in accordance with their actual function in the loan.

Because of that, the current practice increases counterparty risk internationally, creating a faultline in the IFA. Once the risk premium is treated as collateral, that money will remain with the borrowers, instead of enriching lenders without consideration.²¹ While this means a reduction of the windfall profits in the short term, lenders will benefit from the reduced default risk in the long term. However, for a reform that serves all market participants, regulators will have to minimize the bankruptcy risk among lenders. Since the debt burden is becoming increasingly unsustainable and the financial system is becoming more and more fragile, a reform of the Basel Accords is urgently required.

The impact of risk premiums on sovereign finance and human rights

Risk premiums apply to all forms of loans and therefore most borrowers are affected – private individuals, corporations and States alike. This begs the question whether it is possible to quantify how much borrowers pay in excess of the actual interest rates.

¹⁹ Draghi et al. (1996).

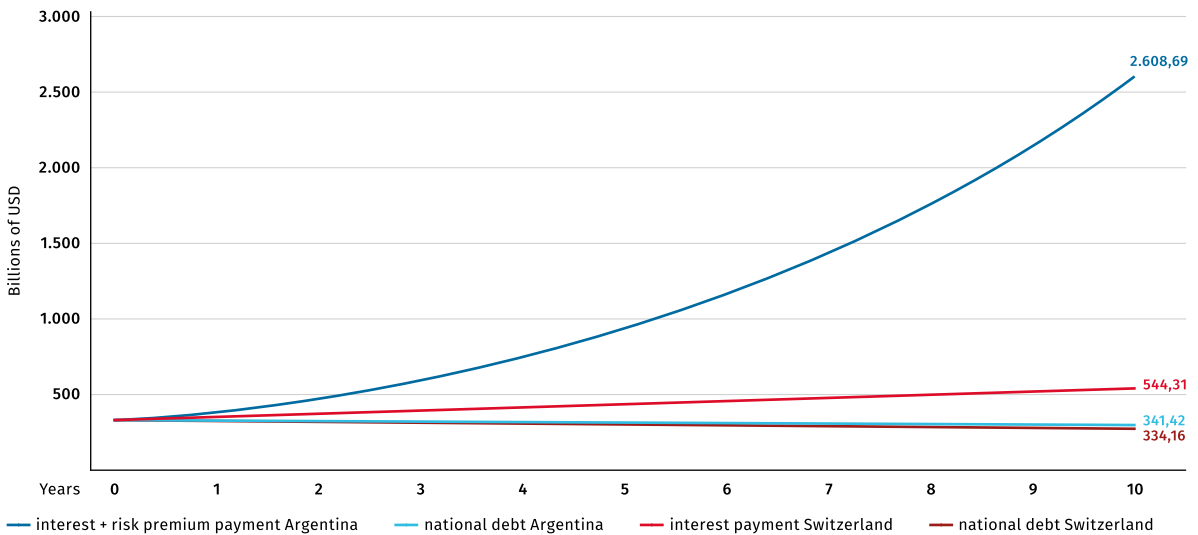
²⁰ Ibid p. 5.

²¹ See the legal concepts of consideration in common law and the synallagmatic contract in civil law.

Based on calculations of the UN Global Crisis Response Group, a total of 3.3 billion people live in countries that spend more on interest payments than on either education or health.²² As a concrete example, Argentina’s national debt amounted to US\$ 341.42 billion in 2023²³ and its country risk premium was 17.55 percent.²⁴ Switzerland’s national debt was similar in 2023, US\$ 334.16 billion²⁵ and in contrast, its country risk premium was 0.00 percent.²⁶ Both states have similar national debt levels, which makes a comparison of the risk premiums’ effect possible if we treat the national debt as one loan over ten years and if we establish a fictitious prime rate of 5 percent. In such a scenario, a 17.55 percent risk premium applies to Argentina, which has to pay a total of US\$ 1,719.948 billion after ten years.²⁷ If we subtract the initial

“principal” of US\$ 341.42 billion, then Argentina has to shoulder US\$ 1,478.528 billion based on the risk premium. Together with the fictitious prime rate of 5 percent, Argentina faces 22.55 percent of compounded interest, which amounts to a total of US\$ 2,608.688 billion after ten years.²⁸ Switzerland, on the other hand, does not incur any debt based on the risk premium over ten years, because the country risk premium is 0.00 percent. As a prime-rate client, Switzerland will pay a total US\$ 544.311 billion after ten years.²⁹ In this case, the prime rate amounts to US\$ 210.151 billion.³⁰ In comparison, Argentina pays US\$ 2,608.688 billion after ten years, minus the principal, a total of US\$ 2,267.268 billion caused by prime rate plus risk premium. Graph 1 illustrates the drastic difference in outcomes.

Figure 1:
Risk premium expenses: Argentina vs. Switzerland



22 UN Global Crisis Response Group (2024), p. 18.

23 Statista: National debt of Argentina from 2007 to 2029 (<https://www.statista.com/statistics/1391782/national-debt-argentina/>)

24 Damodaran (2024).

25 Statista: National debt of Switzerland from 2019 to 2029 (<https://www.statista.com/statistics/531962/national-debt-of-switzerland/>)

26 Damodaran (2024).

27 Duration $n = 10$ years, risk premium $r = 17.55\%$ and principal $K_0 = 341.42$ billion: $K_n = K_0 \cdot (1+r)^n = 341.42 \text{ billion} \cdot (1.1755)^{10} = 1,719.948$ billion.

28 Conditions like fn 27, plus a prime rate $p = 5\%$: $K_{10} = K_0 \cdot (1+p+r)^n = 341.42 \text{ billion} \cdot (1.2255)^{10} = 2,608.688$ billion.

29 $K_{10} = K_0 \cdot (1+p)^n = 334.16 \text{ billion} \cdot (1,05)^{10} = 544.311$ billion. Of course, 5 percent interest is for comparison only; in reality, public bonds of the Swiss Confederation pay interest rates of 0.5 to 1.5 percent and very rarely reach above 3 percent and their maximum of 4 percent. See: https://www.snb.ch/en/publications/financial-markets/gmdh/ch_bonds_res.

30 $K_{10} - K_0 = 544.311 \text{ billion} - 334.16 \text{ billion} = 210.151$ billion.

The correlation of Argentina and Switzerland illustrates the drastic difference that riskier states face based on the risk premium, even if they manage to repay the loan just as successfully as a prime rate state with a comparable debt burden. The fulfilment of the right to development is becoming a distant prospect in Argentina with debt burdens like this.

This example clarifies the mechanism by which lenders obtain these funds, which replace collateral. The risk premiums appear to be a major factor for the lack of funds in the public and private sector, and contribute to persistent wealth inequality.³¹ Although the country risk premiums are only market driven, they are at prohibitively high levels and actually increase the likelihood of defaults by placing the greatest burden on those with the lowest economic capacity. From the perspective of development, this is counter-productive.

In comparison, debt relief in the form of debt cancellation or from reducing interest rates, which has also been one of the proposals put forward by the United Nations Secretary General's Sustainable Development Goal Stimulus Package,³² will help in the short term. However, it will not resolve the problem that is caused by the confusion of price and property. For States to fulfill their human rights obligations, debt relief must be the first step, followed by a comprehensive overhaul of the IFA.

Policy recommendations

Although the legal framework of the IFA seeks to facilitate international borrowing and lending in a stable environment, the international financial system has faultlines. Some of the mechanisms lead straight to an increase of debt, such as the International Monetary Fund (IMF) surcharges,³³ while others have been poorly understood, such as the risk premiums, which were instructed by the Basel Accords.

Therefore, policy recommendations need to address the formal and material aspects of IFA reforms:

The Basel Accords are implemented in the G20 Member States,³⁴ which means that the world's largest economies and most jurisdictions connected with them are obliged to use risk-weighted interest rates.³⁵ A G20 decision to treat risk premiums legally as collateral would therefore affect developed as well as developing countries immediately because it would release funds in their budgets for development and research, for example. In the specific case of risk premiums, it is necessary to:

1. Carry out further research on risk premiums and their effects on lenders and borrowers.
2. Amend the Basel Accords to treat risk premiums as collateral *sui generis*.
3. Introduce real-risk adjustments of risk premiums for the loans of development banks and other multilateral lenders, for bilateral loans and in the private sector.

International human rights law also calls for the correction of the Basel Accords and national laws so that property, price and collateral are treated adequately and that an adjustment of risk premiums over time, in accordance with the real risk, takes place. This is the only way to reduce interest rate-based discrimination. The Guiding Principles on Human Rights Impact Assessment of Economic Reforms, for example, demand that “[m]onetary policies should be coordinated and consistent with other policies with the aim of respecting, protecting and fulfilling human rights”. Furthermore, “[f]inancial sector regulation is required to identify, prevent, manage and fairly allocate the human rights risks created by financial instability (...)” while “[d]ebt policies should be consistent

31 For example, in the USA the overall wealth has grown but the gaps remain, see Hernández Kent/Ricketts (2024).

32 UN Secretary-General (2023), pp. 3–5 and 15.

33 Bohoslavsky/Clérico/Cantamutto (2022).

34 Financial Stability Board (2019).

35 An up-to-date version of the Basel Framework and risk-based capital requirements is also available through the Bank for International Settlements. See https://www.bis.org/basel_framework/index.htm.

with broad goals related to sustainable economic development and the realization of human rights”.³⁶

Conclusion

As long as risk premiums are not adjusted to reflect diminishing risk over time, the financial economy remains skewed in favour of low-risk clients and lenders. This imbalance increases fragility due to imprudent lending and the excessive burden on borrowers from risk premiums that should only serve as collateral. Reforming the Basel Accords would therefore improve the situation for public and private actors alike.

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36 United Nations Human Rights Council (2019), in particular Principle 11 (c), (d) and (e), and 11.10.

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