

**Call for Contributions by the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights**

2021.06.04.

- Topic: **International debt architecture reform and human rights**
- Contribution submitted by: Oliver Pahnecke, PhD candidate Middlesex University and Juan Pablo Bohoslavsky, Former UN Independent Expert on Debt and Human Rights (2014-2020)
- Section: Academics and individuals
- Question addressed: 7. If there are legal, policy or regulatory frameworks that can assert the primacy of access to essential services over the repayment of foreign debts, please explain and provide relevant documentation.
- Synopsis: Identical products have the same price for everybody, except in the case of loans. Due to risk premiums, some (both State and private) borrowers pay more than others for the same loans to protect lenders from the possible defaults of risky borrowers. This current business practice ignores that paid instalments reduce the risk over time and that risk premiums and collateral can be exchanged. Therefore, risk premiums have to be adjusted according to the diminishing risk or to be returned after there is no more need to secure the underlying claim for payment of the loan, like any other collateral. For that reason, the contributors propose a new legal approach to risk premiums in interest rates in order to improve the Basel Accords by a) treating interest rates as the price for loans instead of treating them as the lenders' property, b) limiting the property protection of lenders to the principal, c) treating risk premiums as a replacement of collateral, as well as d) preventing discriminatory pricing based on property status. Consequently, the amount of foreign debt would shrink and significantly increase funds available for access to essential services.

## I. Interest Rates and Human Rights: Reinterpreting Risk Premiums to Finance the Green New Deal and the Fight Against COVID-19

The primacy of access to essential services over the payment of loans and other financial obligations is too often not guaranteed. This is one of the shortcomings of the current international financial practice. As a result, funds for basic services are insufficient and human rights are curtailed.

As we point out in this contribution on the legal character of the risk premiums in interest rates, the interplay between collateral and risk premiums on the one hand and a holistic interpretation of human rights law in the financial field on the other, such as the prohibition of discrimination based on property, are currently wrongly understood. Our approach<sup>1</sup> adjusts the current system, reduces the financial burden and protects human rights.

Risky (both State and private) borrowers pay more for the same loans than low-risk clients due to risk-weighted interest rates that are based on the absence or quality of collateral. This approach treats collateral and risk premium in interest rates as exchangeable<sup>2</sup>, but why then is the collateral returned at the end—while the risk premium is not? This question leads to a new interpretation of risk premiums built into the interest rates of loans that could release funds needed urgently to fight climate change and COVID-19.

Just like landlords letting houses or apartments, banks are letting money to clients for a certain period of time in the form of loans. But while prices for rental cars and apartments depend solely on the market and are the same for each client, the different prices for loans are justified by the higher risks posed by those with poorer property status.

The price for the loan is the interest rate. Instead of the banking industry's obsolete "cost-plus loan-pricing model"<sup>3</sup>, banks and other financial institutions are now using the "price-leadership model" due to increased competition and deregulation to determine the price of loans<sup>4</sup>. Using the price-leadership model, for short-term loans, the bank offers its most creditworthy client a *prime rate* (also called a *base rate*), which serves as a yardstick for all other loans offered to less creditworthy clients. Credit scoring and credit rating (in the case of states and corporations) are risk-pricing tools to determine the risk premium added to the prime rate and must be paid by all riskier clients. If the clients' cash flow and the sum of the loan are identical, two main factors influence the risk premium: the collateral offered and the duration of the loan. The lender's risk decreases if the loan is secured by valuable collateral. And since the borrower's ability to pay the loan is less likely to change in the near term than in the long term, the lender's risk decreases as the loan term shortens.

These risk premiums are ubiquitous, having their origins in the work of the Basel Committee on Banking Supervision (BCBS), which aims to stabilize the international financial architecture. As a result of the Basel Committee's work, weighing credit risk has formed part of the architecture of international banking supervision for more than three decades. In accordance with the Basel

1 This proposal is further developed by the contributors in "Interest Rates & Human Rights: Reinterpreting Risk Premiums to Adjust the Financial Economy," *Yale Journal of International Law*, 2021, available at [https://cpb-us-w2.wpmucdn.com/campuspress.yale.edu/dist/8/1581/files/2021/04/Pahnecke\\_Bohoslavsky-Interest-Rates\\_\\_Human\\_Rights.pdf](https://cpb-us-w2.wpmucdn.com/campuspress.yale.edu/dist/8/1581/files/2021/04/Pahnecke_Bohoslavsky-Interest-Rates__Human_Rights.pdf)

2 Deutsches und europäisches Bank- und Kapitalmarktrecht § 13 at 3 (Peter Derleder, Kai-Oliver Knops and Heinz Georg Bamberger eds., third edition, 2017).

3 Matthew D. Diette, *How Do Lenders Set Interest Rates on Loans? A Discussion of the Concepts Lenders Use to Determine Interest Rates*, Federal Reserve Bank of Minneapolis, November 1, 2000 (<https://www.minneapolisfed.org/article/2000/how-do-lenders-set-interest-rates-on-loans>).

4 Diette, *supra* note 3; *accord* Deutsches und europäisches Bank- und Kapitalmarktrecht § 14 at 5 (Peter Derleder, Kai-Oliver Knops and Heinz Georg Bamberger eds., third edition, 2017).

Accords, the world's largest economies—and most jurisdictions trading with them—use risk-weighted interest rates<sup>5</sup>. Apart from determining risk premiums and interest rates, the interest calculations are decisive for financial burdens, regardless of whether the clients are States, businesses or individual persons. The finance industry's standard is compound interest in combination with risk premiums because of weighted risk, and, therefore, the economic outcome of compound interest is very different in comparison to simple interest.

It is, therefore, important to clarify the legal character of the risk premium by analysing what the risk premium does for both sides of the loan contract. Obviously, the risk premium is not an insurance premium, and the finance industry uses credit default swaps in order to prevent risk exposure. As its name already suggests, the risk premium also does not serve as compensation for regulatory expenses. Risk premiums in risk-weighted pricing do not work as mixed calculations, either: "Using risk-based pricing, the borrower with better credit will get a reduced price on a loan as a reflection of the expected lower losses the bank will incur. As a result, less risky borrowers do not subsidize the cost of credit for more risky borrowers."<sup>6</sup>

A practically riskless client with excellent collateral poses no risk to the lender, even if the full payment of the principal is completed at a later stage. But defaults of borrowers without or with poor collateral are particularly risky at the beginning of the loan because the lender cannot recover the principal when few payments have been made. If simple interest rates and no risk premiums were applied in these situations, a risky borrower would pay the full principal to the lender only at a very late stage of the loan. Yet, combined with compound interest, the risk premium serves as a payment accelerator that helps the borrower pay the principal more quickly to the lender. The risky phase at the beginning of the loan where no or only poor collateral is available is shortened, while the paid instalments reduce the risk over time. At one point, the simultaneous payments of redemption (also called amortisation payments) and interest reach the total amount of the principal. This is the moment at which the risk for the lender to lose the invested principal has dropped to zero. For the rest of the credit's duration, the payments cover only the interest rate, meaning the price of the loan. The risk premium can be exchanged with collateral, and this accelerates payments in the critical first phase of loans to riskier clients, thus adding safety for the lender.

Therefore, it is correct to speak of the risk premium as a collateral *sui generis*. It is the collateral-substituting character of the risk premium that protects the lender's principal, while it makes credit available to the borrower with poor or no collateral.

*Ex-ante*, each client poses a different risk to the lender's investment, the principal, which necessitates different risk premiums in order to prevent losses. But the borrower's real risk can be determined only *ex-post*. Should risky clients turn out to be as reliable in repaying their loans, different prices for the same loans are not justified but turn into discrimination based on property, which is prohibited by a variety of legal sources in international law.<sup>7</sup> A growing body of case law also supports the prohibition of any discrimination that is based on property.<sup>8</sup> Different prices for

5 An up-to-date version of the Basel Framework and risk-based capital requirements are also available through the Bank for International Settlements: *The Basel Framework*, Bank for Int'l Settlements ([https://www.bis.org/basel\\_framework/index.htm](https://www.bis.org/basel_framework/index.htm)).

6 Diette, *supra* cit.

7 On the prohibition of discrimination based on economic status, see the U.N. Committee on Economic, Social and Cultural Rights, General Comment No. 20, *Non-discrimination in Economic, Social and Cultural Rights*, E/C.12/GC/20, July 2, 2009; for further information on the prohibition of discrimination, see, for example, European Court of Human Rights' *Guide on Article 14 of the European Convention on Human Rights and on Article 1 of Protocol No. 12 to the Convention – Prohibition of Discrimination*, 15, December 31, 2019 ([https://www.echr.coe.int/Documents/Guide\\_Art\\_14\\_Art\\_1\\_Protocol\\_12\\_ENG.pdf](https://www.echr.coe.int/Documents/Guide_Art_14_Art_1_Protocol_12_ENG.pdf)).

8 See, for example, *Shelter Corp. v. Ontario (Human Rights Comm.)*, 2001 CanLII 28414 (ON SDC); *Chassagnou and others v. France* [GC, 29. April 1999], nos. 25088/94, 28331/95 and 28443/95, ECHR 1999-III; Magyar Alkotmánybíróság [Hungarian Constitutional Court] December 18, 2012, 42/2012 (XII. 20.) AB határozat (Hung.); HUN-2012-3-008 (<http://www.codices.coe.int/NXT/gateway.dll/CODICES/precis/eng/eur/hun/hun-2012-3-008 - English summary>).

the same credit under equal risks can be prevented either by returning the risk premium at the end of the loan—or adjusting the risk premium/interest rate over time along with the diminishing risk<sup>9</sup>, thus achieving identical prices for all clients.

Returning the risk premium is possible because it is only part of the interest rate, meaning the credit's market price, and not the lender's property. Therefore, the risk premium should be returned like any other collateral as soon as the lender's investment—the principal—is fully paid by the borrower.

A discriminatory practice closely connected to risk premiums are the IMF's surcharges that usually the poorest countries are burdened with. The IMF applies surcharges of 2% or 3 % based on how long payments are overdue and once a certain threshold has been reached. In times of near-zero or even negative interest rates, these surcharges, which are not market driven and depend solely on the IMF, are strikingly high. They are not a collateral *sui generis* accelerating payment as discussed in this contribution but merely a sanction for being poor that is applied against the poorest countries, thus driving them even more into debt. As they do not help protect the IMF's investment, the existence of these surcharges is not justified, and their use should be abolished.<sup>10</sup>

## II. Final remarks

Treating risk premiums as collateral, limiting the property protection to the principal as well as preventing discriminatory pricing based on property status is new and certainly contradicts current financial practices, but the problems connected to the legal character of the risk premium need to be discussed and addressed. Upholding risk-premium payments fully throughout the duration of the loan agreement, without adjustment corresponding to the decreasing default risk, runs contrary to the public interest, violates the prohibition of discrimination and frequently infringes upon borrowers' human rights.

Adjusting interest rates and risk premiums after the full payment of principal prevents discrimination by securing the equal treatment of all borrowers once they have fulfilled their principal-payment obligation. It would free up the resources of the poorest borrowers to improve their living conditions, enable sovereign borrowers to implement poverty-eradication policies, facilitate businesses and create wealth for corporate borrowers. Using the full payment of the principal as a precondition for equal-payment conditions among borrowers strikes a balance between the interests of the lender and the borrower. This approach creates no additional burden for lenders; it simply corrects a poorly constructed finance practice without interfering with freedom of contract or market forces by treating interest rates as prices rather than property.

This approach would also release resources during the current dramatic COVID-19 context, in which fiscal space and household incomes must be devoted to save lives and ensure that basic economic and social rights are realised. So far, quantitative easing (QE) has not been a successful booster of the economy, but if interest rates were adjusted and risk premiums returned, a lot of money would remain in the pockets of those needing it most: States fighting COVID-19, enterprises needing investable capital and citizens struggling to meet their daily needs.

The proposed approach is likely to contribute to a more stable financial system in three ways:

9 Similar to the approaches of Austrian and German courts in cases of excessive collateral; see BGHZ 137, 212, 218 and Österreichisches Bankvertragsrecht–Band VIII: Kreditsicherheiten, Teil I (Peter Apathy, Gert Michael Iro and Helmut Koziol eds., second edition, 2012) nr. 1/170, fn. 612 and 613.

10 See also Kevin P. Gallagher, *The IMF's surcharges are unfit for purpose - It's time for a rethink*, Financial Times, Mar. 4, 2021, <https://www.ft.com/content/cc82f5bf-36c6-454f-b7f0-a4a18576ff2b>.

First, borrowers will no longer be unduly burdened. Private and sovereign defaults should become less likely, and more resources would be available for investment or for the realization of human rights.

Second, if borrowers knew that their higher-risk premiums would lead to the faster payment of principals and, therefore, to the same price levels that prime-rate clients enjoy, they would be motivated to maintain regular payments, which could make the whole financial system less exposed to risks. Additionally, knowledge about the adjustment of interest rates could bring about a welcome side-effect by making borrowers more interested in the details of loans, thus contributing to an overall improvement of financial literacy.

Third, the new approach is likely to reduce moral hazard and correct the current incentive structure. At the moment, it is extremely profitable to issue loans to risky clients. Because of the additional revenue that high-risk borrowers must pay relative to low-risk borrowers, the former are currently the more attractive clients. Even if it becomes foreseeable that riskier clients may default in an upcoming economic downturn, it is easy to sell the claim against them if the rating is good. Were contracts with riskier clients rated in correspondence with the real risk development over time, the market price would be far more realistic. This could correct the misleading incentive structure currently in place, which is based on too-high-yield promises, without making loans to risky clients unattractive.

Based on the Basel Accords, banks are already required to adjust their risk-management data at least quarterly. Therefore, banks are already legally obliged to collect the data necessary for the adjustment of interest rates and return of risk premiums to their clients. While this may lead to less profit in the short term, banks would benefit from more reliable risk and a more stable financial market in the long run, as defaults are less likely to occur, which also threaten banks occasionally.

All states, in particular G20 member states, should live up to their human-rights obligations and protect the property of their citizens and corporations by introducing regulations that would require banks to pass on such client-related savings by returning the risk premiums in accordance with risk adjustments over time instead of letting finance institutions keep these savings as windfalls. This approach might reduce the need for increased taxes and money printing while contributing to the financing of the Green New Deal and the fight against COVID-19.