



USAID EAST AFRICA TRADE AND INVESTMENT HUB

AN ANALYTICAL REVIEW OF THE STATE OF TRADE FINANCE IN AFRICA

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DISCLAIMER

The authors' views expressed in this report do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

PURPOSE OF REPORT

This report was prepared by Kefa Nyakundi, a consultant to Development Alternatives International (DAI) on behalf of the African Union Commission Department for Trade and Industry as a key input for discussion at the African Union Workshop on “Trade Finance and Trade Information” held in Dar-es-Salaam, Tanzania September 13th-15th, 2017. It was commissioned by USAID East Africa Trade and Investment Hub for the African Union Commission (Department of Trade and Industry) which served as the Secretariat for the Workshop. Questions about this report may be addressed to the author (knyakundi@e-innovativecapital.com) or to Yohannes Assefa, Director for Agriculture and Agribusiness for the East Africa Trade and Investment Hub (yassefa@eatradehub.org).

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ACRONYMS AND ABBREVIATIONS

ACM	African Common Market
AEC	African Economic Commission
AfDB	African Development Bank
AMU	The Arab Maghreb Union
AU	African Union
BCT	Block Chain Technology
BIAT	Boosting Intra African Trade
BIS	Bank for International Settlements
CGFS	Committee on the Global Finance System (of BIS)
CFTA	Continental Free Trade Area
CEN-SAD	Community of Sahel and Saharan States
CET	Common External Tariff
DAI	Development Alternatives Inc.
DTI	Department of Trade and Industry
EADB	East African Development Bank
EATIH	East African Trade and Information Hub
ECCAS	Economic Community of Central African States
ECOWAS	Economic Community of West African States
FTA	Free Trade Area
GFC	Global Financial Crisis
GDI	German Development Institute
ICC	International Chamber of Commerce
IGAD	Inter-Governmental Authority on Development
LCs	Letters of Credit
LPA	Lagos Plan of Action
MFBs	Multi-Lateral Development Banks
MNCs	Multi-National Corporations
MSMEs	Micro, Small and Medium Enterprises
NEPAD	New Partnership for Africa's Development
NPCA	NEPAD Planning and Coordinating Agency
OAU	Organization of African Union (Now known as the AU)

OECD	Organization for Economic Co-operation and Development
RECs	Regional Economic Communities
SADC	Southern African Development Community
SCF	Supply Chain Finance
SMEs	Small and Medium Enterprises
SWIFT	Society for Worldwide Interbank Financial Telecommunication
SME	Small and Medium Enterprise
TDR	Trade and Development Report (by UNCTAD)
TFTA	Tripartite Free Trade Area (made up of COMESA-EAC-SADC)
UNCTAD	United Nations Conference on Trade and Development
UNECA	United Nations Economic Commission for Africa
USAID	United States of America International Development agency
USITC	US International Trade Commission
WTO	World Trade Organization

EXECUTIVE SUMMARY

Trade is ‘...a basic economic concept involving the buying and selling of goods and services, with compensation paid by a buyer to a seller...’¹ The buyer and seller could reside in the same or different countries. This remit of this assignment is restricted to cross border trade which has various benefits to both exporting and importing countries including, but not limited to creation of variety for consumption; creation of efficiencies through the concept of comparative advantages; creation of employment opportunities and therefore alleviation of poverty and economic inclusion²; regulation of prices as countries strive to remain competitive; increased foreign exchange earnings; and fostering peace owing to economic interdependence, among others.

The importance of trade as the cornerstone of economic development to Africa is exhibited by such countries like Botswana, Mauritius and Namibia who have catapulted themselves from low income to middle income countries by improving their ability to trade in regional and global markets. Increasing trade therefore has the potential to significantly change the economic order globally. According to WTO, however, while global trade has been responsible for generating growth and employment in many developing markets, progress has, in most cases, ultimately been secured by improving links with regional neighbours.

Source: UNCTAD - Trade and Development Report (TDR) 2016

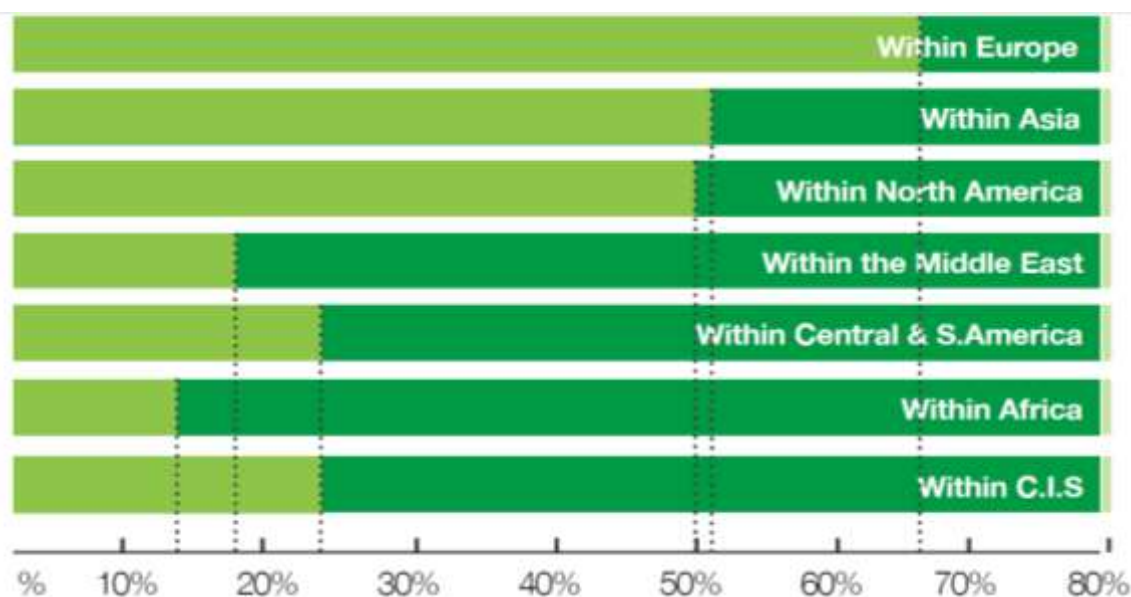


Figure 1: Global Intra-Regional Trade (%)

From the above table, intra-Europe is recorded at 66%, intra-Asian trade at about 52% and intra-North American trade at 50%. In contrast, intra-African trade is recorded at about 15% which corroborates the fact that intra-regional trade leads to greater economic development.

As supported in the schematic below, the Asian success story further accentuates the fact that for faster economic development, intra-regional trade (in addition to trade with the rest of the world) is a necessary ingredient.

¹ Investopedia

² <https://www.economist.com/news/leaders/21578665-nearly-1-billion-people-have-been-taken-out-extreme-poverty-20-years-world-should-aim>

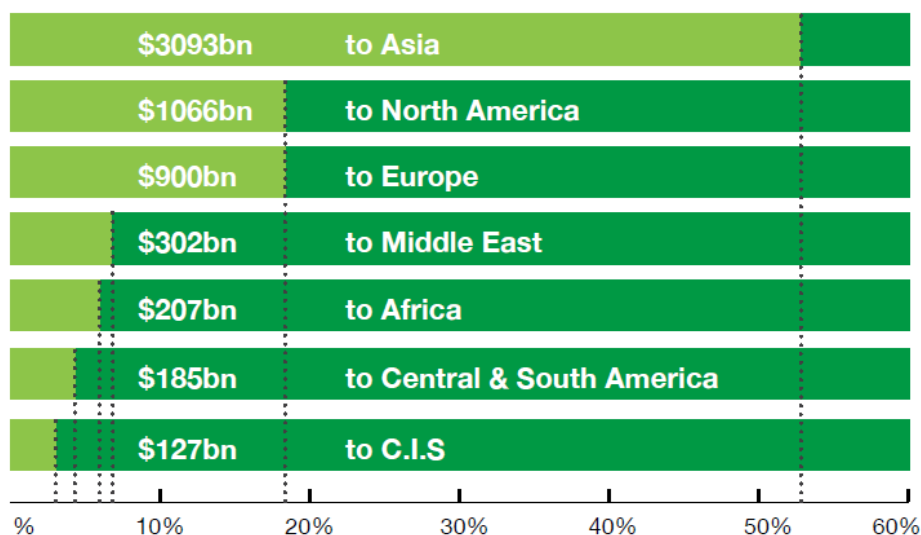


Figure 2: Asian Exports (in \$Bn and %)

The importance of building strong regional markets in developing economies is believed to help insulate the countries from external shocks that may emanate from the industrialized world.

It is instructive that SMEs, i.e. companies defined as employing 250 or fewer workers constitute the vast majority of companies registered in both developed and developing countries. They therefore play a major role in economic activity, generating growth and innovation. According to the World Bank, SMEs contribute to over 60 per cent of total employment in developed countries and 80 per cent in developing ones, including the estimated informal sector (World Bank, 2013). Also, according to figures from OECD, SMEs account for 40 per cent of exports of OECD countries, and a somewhat smaller share in developing countries, where concentration of exports is highest among the largest firms (World Bank, 2013).

It therefore follows that SMEs are a significant stakeholder in any strategy to improve cross-border trade. This implies a need to address liquidity, a key barrier that prevents SMEs from participating in the growth of cross-border trade. With the cost of trade still high in the developing world – far higher than in industrialized economies – SMEs face significant challenges in accessing the credit they need to get their goods to market.

Trade financing may be provided either through the banking and financial system (Bank-intermediated or documentary credit) or directly between trading partners (open account). Traditional trade finance refers to the former and conceptually consists of four core aspects: payments, financing, risk mitigation and information (Malaket, 2014). The figure below helps to flesh out some details

Payment	Financing	Risk Mitigation	Information
<ul style="list-style-type: none"> Secure Timely & prompt Global Low-cost All leading currencies 	<ul style="list-style-type: none"> Available to importer or exporter Several stages in the transaction No impact in Operating Line for exporters 	<ul style="list-style-type: none"> Risk transfer Country, banker, and commercial risk Transport insurance Export credit insurance 	<ul style="list-style-type: none"> Financial flows Shipment status Quality shipment Letter of Credit systems include web & desk top solutions

Figure 3: Trade Finance Value Chain (Adopted from Opusadvisory)

The challenges with the traditional financing facilities were laid bare during the international financial crisis where many financiers pulled back liquidity from emerging markets and from trade finance more generally in order to cover positions in their home jurisdictions. Local financial institutions found it hard to access credit in international markets, with considerable knock-on effects for SMEs, while international banks sought to reduce their exposure to emerging markets to protect their core interests. This withdrawal reduced the already limited access to credit in most of Africa. A sad statistic is that African countries, and by extension, their financial institutions are considered risky by the rest of the World. Naturally, African businesses bear the financial implication of this labelling through the high cost of trade finance as, for instance, all LCs issued from the continent in favour of other regions must be confirmed. The matters are further exacerbated by the relatively small balance sheets of African financial institutions, not to mention the US\$ liquidity challenges given that about three-quarters of LCs are issued in US Dollars.

However, non-traditional financing mechanisms that include factoring, supply chain finance, forfaiting, among others also exist. There is very little knowledge of their existence though recent technological innovations are slowly blurring the lines between the two, through the emerging Fintech's that are collaborating with Banks and other Financial Institutions to bring liquidity into open account trade. Bank Payment Obligations may be called a digitized/digitizing the traditional LC.

Whereas various surveys globally by, among others, the US International Trade Commission (USITC) show that SMEs consider the process of obtaining finance for conducting cross-border trade “burdensome” and that lack of access to credit as one of the top three constraints for SME firms seeking to export or expand into new markets; the situation in Africa is rather dire and may be considered ‘a market failure’ if looked at both from the supply-side and demand-side challenges.

Unlike in the developed countries, banks are relatively more conservative about supporting local exporters and importers; local banks lack the capacity, knowledge, enabling regulatory environment, international network and/or foreign currency to supply import- and export-related finance. Equally, traders are largely not aware of the available products, or of how to use them efficiently. That most African exports rely on Bank-intermediated finance than other regions (German Development Institute (DI, 2015) helps to put matters into perspective. This over-reliance on bank-intermediated trade finance, against a background of capacity-challenged Banks with small balance sheets which are further constrained by prudential regulatory guidelines is a significant impediment for intra Africa Trade. Research by AfDB shows that the value of Bank-intermediated trade in Africa is approximately 350Billion which is equivalent to a third of total African trade. Of this value, the share devoted to intra-Africa trade is around 68 Billion. Given that the share of intra-African trade is 74 Billion or 19% of the total African trade, it is instructive that Africa needs to address the trade finance-related challenges in order to improve trading within the continent. One observation is that Banks finance about 30% of the trade finance need in Africa (globally this has declined to well below 20%). This implies that 70% or more of trade in Africa is on open account. This presents the best opportunity to improve intra-Africa trade and significantly impact the continent.

As opposed to taking protectionist measures as recent global trends may seem to suggest, Africa must seek to promote market-led initiatives to spur the private sector into action to fill the yawning trade gap. The lowest hanging fruits are deployment of large scale financial awareness programs to enlighten SMEs on financing options available and their benefits. This would help the uptake of non-traditional instruments such as factoring, supply chain finance, and BPO, as well as traditional products like credit insurance. There is also need alignment of available liquidity to the effective demand through harnessing the power of innovation; setting up of sizeable trade finance funds to catalyze the market; facilitating collaboration between financial institutions and Fintech's to remove information asymmetry, reduce risks and create efficiencies in trade; promoting the

distribution of trade finance assets in the secondary market order to attract more capital from banks and non-bank investors to finance trade; among other initiatives. In particular, the use of Technology-led Supply Chain Finance as well as the adoption of Block Chain Technology require special attention for the continent. A key aspect is the expansion of the ‘risk enhancement industry’ – particularly trade credit insurance and guarantee schemes across the continent.

Address the challenges of bank-intermediated trade finance calls for the involvement of Government. Through the various MFBs and DFIs, Governments could help address the balance sheet capacity through MDBs, whose strong financial backing and credit ratings, could create facilities that can de-risk transactions for commercial banks and help to promote trade. They could also play a role in trade facilitation programs

Governments could also come in to assuage regulatory pain. Basel 3’s liquidity, capital and leverage requirements are designed to encourage banks to incorporate trade finance into their leverage calculations, by factoring in short term contingent liabilities relating to trade finance. This could push banks with capital constraints out of the market. Limited support from international banks for African trade finance means that African banks must take the lead. Trade finance default rates are higher in Africa than in the rest of the world, averaging 4³ per cent in comparison with a global average of less than 1 per cent. (Average default rates for all Assets range from 4% in South Africa to 12% in West Africa).

In all, it is increasingly clear that Banks globally will be unable to materially close the trade finance gap. Whereas the global economic system has recuperated to the pre-crisis liquidity, it is disproportionately available to MNCs and large corporates and consistently unavailable to MSMEs. Owing to their dispersed nature and small ticket nature, financing of MSMEs requires automation in order to reduce costs and improve efficiency. Automation makes it easier to innovate financial products to facilitate trade. Africa must quickly join the rest of the World.

³This varies from an average of 1.1% in South Africa to 6.3% in West Africa

I. GENERAL BACKGROUND AND CONTEXT

I.1 Introduction

The January 2011 Summit of the African Union endorsed the recommendation of the 6th Ordinary Session of the AU Ministers of Trade held in Kigali from 29 October – 2 November 2010 to fast-track the establishment of a Continental Free Trade Area (CFTA). The January 2012 African Union Summit of Heads of State and Government endorsed the action plan for “Boosting Intra-Africa Trade” (BIAT).

The Agenda 2063 framework was mooted in 2013 as a framework for structural transformation of Africa to mark the AU Golden Jubilee in 2013 in tandem with the AU vision “*to build an integrated, prosperous and peaceful Africa, an Africa driven and managed by its own citizens and representing a dynamic force in the international arena*”. Under Agenda 2063, the following emerged as the seven common set of aspirations for Africa:

- 1) A Prosperous Africa based on inclusive growth and sustainable development;
- 2) An Integrated Continent, Politically United, based on the ideals of Pan Africanism;
- 3) An Africa of Good Governance, Respect for Human Rights, Justice and the Rule of Law;
- 4) A Peaceful and Secure Africa;
- 5) An Africa with a strong Cultural Identity, Values and Ethics;
- 6) An Africa whose development is people-driven, especially relying on the potential offered by its women and youth; and
- 7) Africa as a Strong, Resilient and Influential Global Player and Partner

Towards this end, the agenda identified 8 priorities for the continent

- i. African Identity and Renaissance.
- ii. Continue the struggle against colonialism and the right to self-determination.
- iii. The Integration Agenda
- iv. Agenda for Social and Economic Development.
- v. Peace and Security Agenda.
- vi. Democratic Governance.
- vii. Determining Africa’s Destiny
- viii. Africa’s Place in the World

I.2 Regional Integration

Regional integration was one of the primary objectives for the establishment of the Organization of African Union (OAU, now the AU). In the mid-1970s, the OAU took steps towards promoting socio-economic development and integration and decided in 1976, to establish the African Economic Community (AEC) by the year 2000. The objective was to address the state of individual countries in Africa which were very fragmented marked by relatively small populations and economic output, leading to limited markets and lack of competitiveness and low economies of scale in the production and distribution of goods and services. The Abuja Treaty envisaged establishing the African Economic Community over a 34-year period in stages starting with the establishment of economic communities in regions.

Currently, there are eight officially recognized Regional Economic Communities (RECs):

- The Economic Community of West African States (ECOWAS);
- The Common Market for Eastern and Southern Africa (COMESA);

- The Southern African Development Community (SADC);
- The Economic Community of Central African States (ECCAS);
- The Intergovernmental Authority on Development (IGAD);
- Community of Sahel and Saharan States (CEN-SAD) and
- The Arab Maghreb Union (AMU).

An urgent measure to promote regional integration was identified as the establishment of the Continental Free Trade Area (CFTA). The Addis Ababa AU Summit of 2014 agreed upon, among others, to fast-track the establishment of the CFTA and the transition to a continental Customs Union with a Common External Tariff (CET) scheme; increase investment in market and trade infrastructure; promote/strengthen multi-stakeholder platforms; and strengthen/streamline coordination mechanisms to promote a common African position on agriculture-related international trade negotiations and partnership agreements.

1.3 Boosting Intra Africa Trade

The BIAT Action Plan has seven critical clusters that include:

- Trade policy;
- Trade facilitation;
- Productive capacity;
- Trade and infrastructure;
- **Trade finance;**
- Trade information;
- Factor market and integration.

The action plan has short, medium and long-term measures to deliver concrete outputs with responsibilities shared between the RECs, Member States and the AU organs. The establishment of the CFTA and its fast tracking will lead to a significant growth of Intra-Africa trade and assist Africa to use trade more effectively as an engine of growth, job creation, reducing poverty and sustainable development.

Under each of the above clusters, the BIAT Action Plan provides, in broad terms, an indicative list of programmes and activities that need to be implemented in the short to long terms at the national, regional and continental levels.

Trade Finance is identified as a major constraint to the growth of Africa's trade, especially inadequacy of financing mechanisms to boost intra-regional trade. It is rightly noted that the paucity of credit and finance for businesses limits their liquidity and undermines their ability to obtain production inputs. Overall, it weakens intra-African trade and diversification efforts.

Some of the priority issues identified include:

- Poorly developed financial markets
- Lack of widely available trade finance for African businesses.

2 GLOBAL TRENDS IN TRADE FINANCE

2.1 Introduction

The United Nations Conference on Trade and Development (UNCTAD) Trade and Development Report (TDR) 2016 indicates that global economic growth has remained weak, growing at a rate below 2.5% in 2016, and global trade slowed down dramatically to around 1.5% in 2015-2016, compared to 7% before the global economic crisis. The decline in world commodity prices in 2015 had a significant impact on the value of merchandise trade.

The global ratio of merchandise trade to GDP that fell sharply in 2009 following the global economic crisis and bounced back quickly in 2010-2011 started to show signs of gradual decline in 2012-2014 it declined gradually, before falling significantly in 2015 -2016.

This is attributed to the loss of dynamism in advanced economies, combined with low commodity prices and global financial instability which has had a knock-on effect on most developing countries. The global slowdown in trade has impacted the growth of developing economies significantly. UNCTAD projects an average growth of less than 4% in developing economies this year, but with considerable variation across countries and regions.

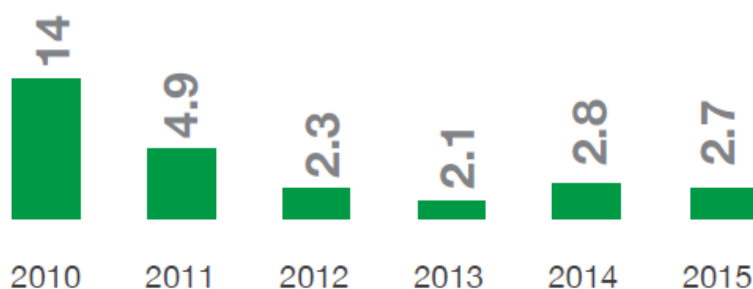


Figure 4: World Trade Growth: Growth in world merchandise exports (in %)

Whereas Latin America is in recession, growth in Africa and West Asia is slowing down to around 2%, East, South-East and South Asia is still growing at a rate close to 5%.

Africa has not, in the modern era, been a major source of exports to the rest of the world. Indeed, as shown in the schematic below, since the 1950s, the continent has seen its share of global trade shrink to half its post-war totals. This is further proof of the need to enhance intra-African trade to shore up performance of individual economies.

	1953	1963	1973	1983	1993	2003	2013	2015
NORTH AMERICA	24.8	19.9	17.3	16.8	18	15.8	13.2	19
SOUTH & CENTRAL AMERICA	9.7	6.4	4.3	4.4	3	3	4	4
EUROPE	39.4	47.8	50.9	43.5	45.4	45.9	36.3	37
COMMONWEALTH OF INDEPENDENT STATES	3.5	4.6	3.7	5	1.5	2.6	4.3	2
MIDDLE EAST	2.7	3.2	4.1	6.8	3.5	4.1	7.4	4
ASIA	13.4	12.5	14.9	19.1	26.1	26.2	31.5	29
AFRICA	6.5	5.7	4.8	4.5	2.5	2.4	3.3	3
VALUE OF WORLD TRADE (IN BILLIONS)	84	157	579	1,838	3,676	7,377	16,301	15,984

Source: WTO

Table 1: Global Exports by Region (%) of world merchandise exports by region, 1953-2015

2.2 Global Trade Finance Gap

Globally, it is well known that there exists a trade finance gap (i.e. the gap between credit demand and credit supply). According to the Asian Development Bank (ADB) 2013 global survey, the global gap at US\$ 1.9 Trillion in 2012 out of which 80% was in Asia. This gap however narrowed to US\$ 1.6 Trillion in 2014. Africa's trade Finance Gap in 2014 was estimated at US\$ 94 billion while the comparative estimated gap was US\$ 120 billion in 2011 and 105 billion in 2012. Although this trend suggests a gradual narrowing of the gap in Africa over time, it is important to note that the gap is still significant.

The ADB survey concluded that the trade finance gap affect SMEs more than any other enterprise with 51% of applications rejected Vs 7% for MNCs.

	SMEs	Non-SMEs
Traditional products		
L/C import financing	18.3	12.2
L/C export discounting	10.9	2.4
Working capital financing	26.5	12.1
Credit insurance	4.5	3.1
Non-traditional products		
Bank payment obligation	8.5	1.7
Supply chain financing	7.5	5.9
Factoring	3.7	0.6
Forfaiting	0.7	0.4

Table 2: Comparison of average rejections (\$Bn) across trade finance platforms

Various studies, notably (Chodorow & Reich, 2014) have shown that withdrawal of credit to SMEs results to at least 33% decline in employment implying that the rejected applications are a predictor of heightened unemployment. The ADB survey supports this by adding the dimension of information asymmetry between the demand and supply side. For example, the survey found out that only 40% of SMEs knew what SCF was despite it being said to be the most likely form of financing that will increase SME exports (Duval et al., 2014).

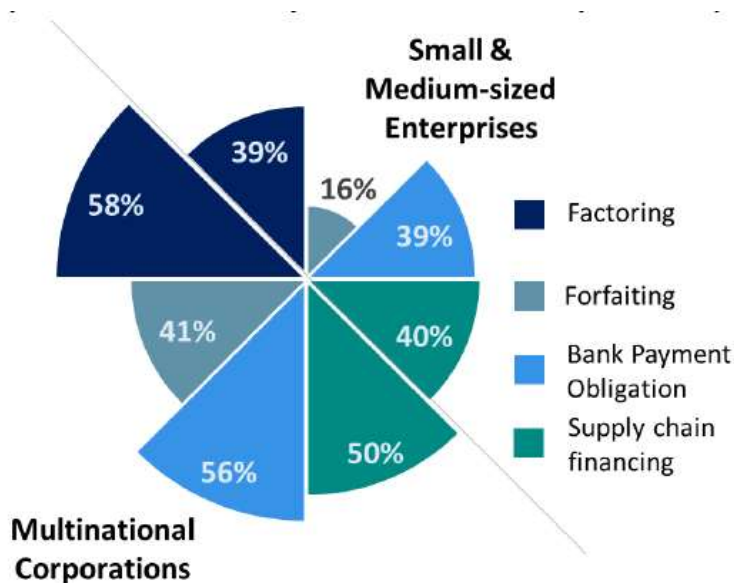


Figure 5: Familiarity with Trade Finance Products (SMEs Vs MNCs)

From the study, it is evident that whereas there is diversification of trade finance instruments globally, this has been limited to bank-mediated instruments.

Transaction type	Volume	Percentage
L/C import issuance	1617	81
L/C export confirmation and discounting	272	14
Working capital for pre-export financing	89	4
Supply chain financing including invoice discounting	20	1

Table 3: Trade Finance gaps by transaction type (USD Billions)

The importance of this trend will become crystal clear when delving into some of the challenges experienced by African Banks later in the report. The obvious conclusion is that there exists an opportunity globally for use of trade financing instruments other than bank finance. Currently, these non-bank instruments are concentrated in their traditional markets in EU and USA – (using factoring as proxy for non-bank financing instruments)

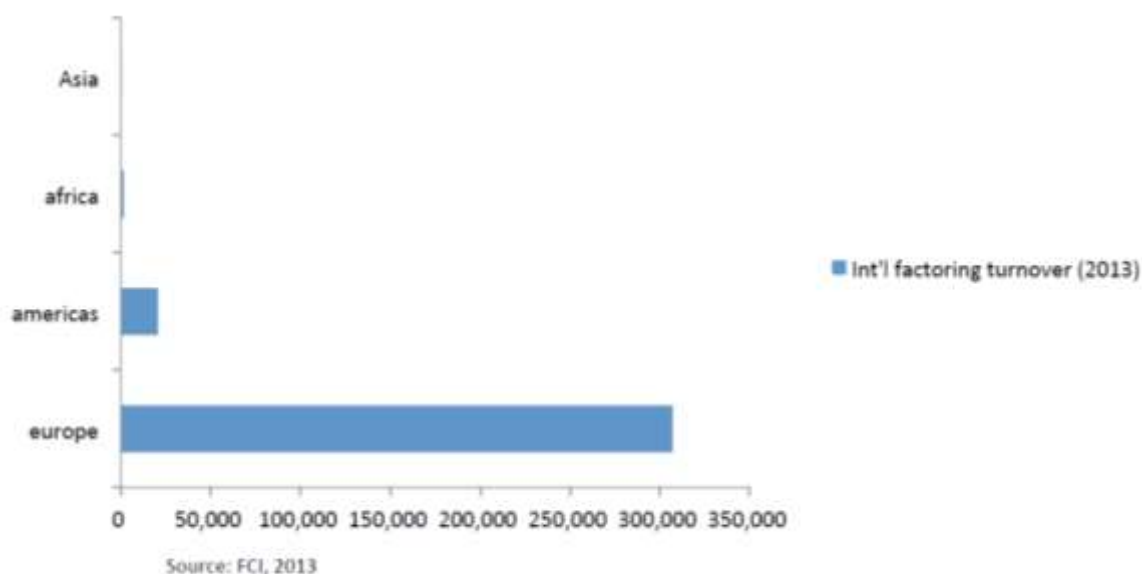


Figure 6: International factoring turnover by value (2013)

An interesting trend from the survey is that whenever applications for trade financing are rejected, the applicants do not seek any alternative either because they do not exist or they are too expensive. In Asia, the split between availability and cost is 50:50. However in Africa, there are very few options available relative to cost. The implication is that the opportunity to introduce non-traditional instruments for financing trade is more compelling for Africa.

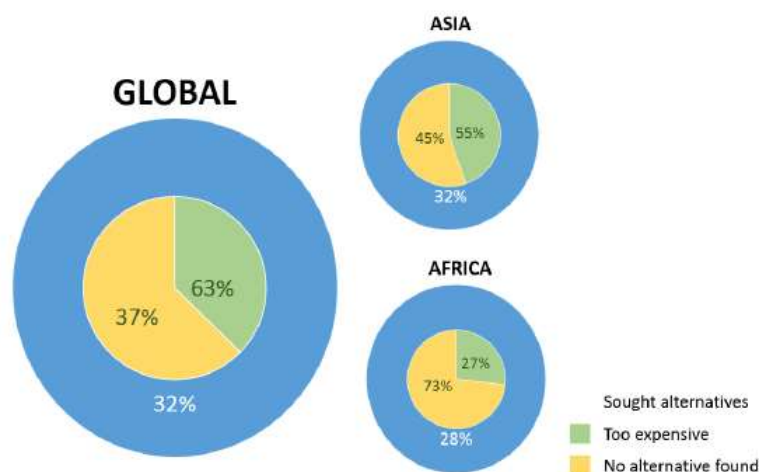


Figure 7: Availability of alternatives to rejected applications

From a general perspective, there are three key areas that lead to rejections of applications for finance and hence impeding access to finance, namely:

- **Borrower characteristics** – these include the characteristics of firms (or individuals) who are the traders seeking finance; the issuing banks that are guaranteeing the trade on behalf of the traders; and the countries of origin of the traders.

- **Governance of the financial system** – These characteristics are related to stringent AML/Compliance requirements by the global financial system. Of most importance is the cost that correspondent banks have to incur to ensure compliance as well as the high penalties levied for non-compliance and stringent requirements. The survey found out that these costs are a significant cause of termination of banking relationships.
- **Demand side inhibitors and information asymmetry.** These are hurdles imposed on applicants to trade finance and are based on perception from the applicants themselves. Critical hindrances include pricing, collateral requirements, long processing time, information/documentation required and lack of existing or previous relationships

During the ADB 2014 survey, the most prominent sentiments among the companies was that prerequisites required for obtaining trade finance are unattainable. Yet another reason appears to be information asymmetries. Seventy-eight percent of companies reported that they would benefit from greater financial education, which was reflected clearly in their lack of familiarity with financial products. In the case of non-traditional products such as factoring, forfaiting, BPO and supply chain finance, less than 40% of companies report familiarity with these instruments.

Even within traditional bank products, companies reported limited familiarity (40%) with relatively established products such as credit insurance

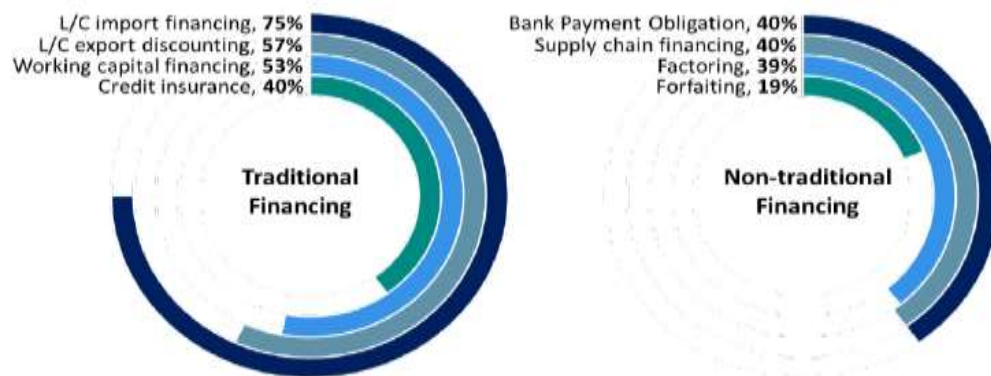


Figure 8: Familiarity with traditional Vs Non-Traditional trade finance products

2.3 Evolving Global Economic and Trade Architecture

“Business today faces an environment with both unprecedented challenges and tremendous opportunities. The challenges come in part from a generalized and deep-seated feeling of dissatisfaction – with government, with markets, with the media - and of disenfranchisement as many feel locked out of growing economies”. These comments by John Danilovich, Secretary General, ICC in their 2017: Rethinking Trade and Finance publication describe the emerging wave of discontent notable through the Brexit decision, the USA Presidential elections that points to a clamour for protectionism which many analysts attribute to the biting effects of the trade financing gap.

In the editorial of the above edition of the annual report on trade finance, the ICC raises concern that banks will be unable to materially close the large trade financing gap, and that there is a misalignment in the availability of funds and liquidity, at least as viewed through a lens that seeks to identify the greatest need.

The global economic system has largely recuperated pre-crisis levels of liquidity; however, it is disproportionately available to multinationals and large corporates – the top end of the market – and consistently absent in the micro, small and medium-sized enterprise (MSME) segment.

2.4 The Emergence of Fintechs

It is a generally-held belief that literary every facet of Banking has changed over the years but trade finance has remained a key area where developments have been modest in comparison, despite its importance in facilitating international trade. Daniel Schmand⁴, sees trade finance gap of more than US\$1.6tr annually as an opportunity for Fintech’s to look for innovative solutions to plug since banks are facing capacity constraints in responding to this opportunity. He sees digitization of trade finance bringing immediate and quantifiable benefits to all participants, including, for instance, elimination of paper from trade finance transaction processing which could reduce processing time by approximately two hours per transaction and reduce compliance costs by 30%!⁵ He sees the dependence of trade finance on a paper environment, while logistics such as container shipping have electronic architectures, as a bottleneck in trade.

Financial Technology (Fintech) companies, many in startup phase, have identified significant opportunities in the financing of international trade, and have the potential to play an important role in progressing a collective effort to narrow, then close, the global trade finance gap.

Respondents in the ADB survey identified priorities linked to digitization and technology, including FinTech and the development of – or adherence to – fast-emerging platform propositions, as priority areas of strategic focus. There general concurrence that FinTechs do not pose any challenge to the Banking industry but rather provide opportunities for collaboration. Fintech’s are emerging in all spheres of financial services including payments, transaction banking, cards and credit origination.

⁴ Daniel Schmand is the Managing Director and Head of Trade Finance and Cash Management, Corporates, EMEA, Deutsche Bank, and Chair of the ICC Banking Commission

⁵ [Waking up the sleeping giant: The potential for Trade Finance Transformation](#)

As depicted in the following graph from Accenture, investments into FinTechs globally have been rising steadily, but poignantly, Africa has been left behind

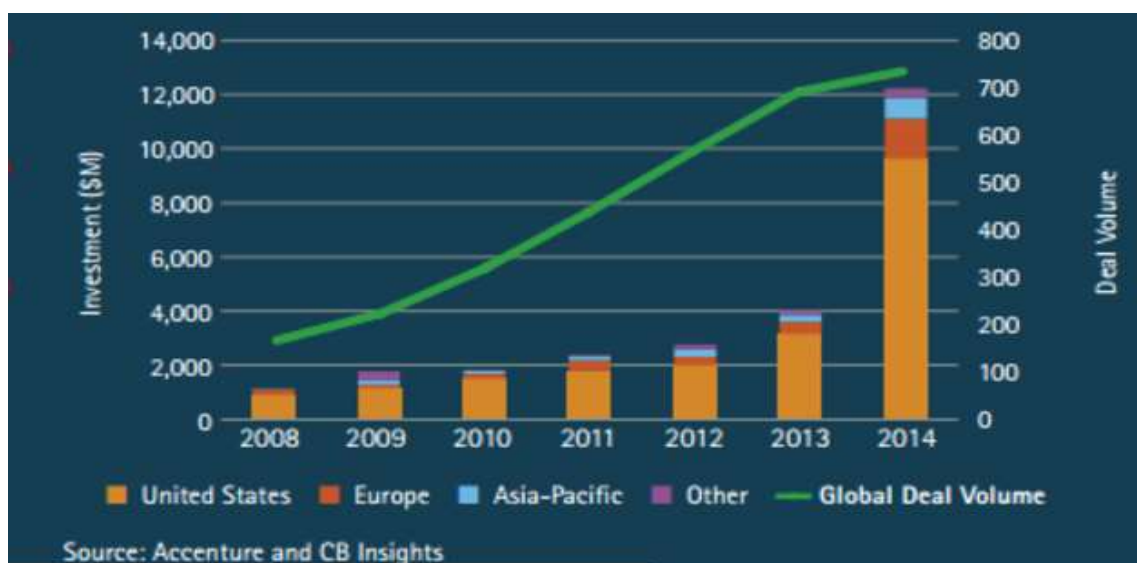


Figure 9: Growth in Investments in Fintechs

Some of the reasons Banks are collaborating with FinTechs include, but are not limited to:

- Unlike Banks which lack agility and speed, FinTechs are faster at Innovation and can help Banks increase/protect market share.
- FinTechs are small and nimble and therefore charge significantly lower fees adding to reduction in overall costs.
- Use of modern 2.0 technology creates more transparency and accessibility for all.
- Perhaps the most important benefit of this collaboration is the capacity of FinTechs to manage Big Data – which has helped global players re-invent the traditional credit evaluation models with feeds from social media, live feed from accounting systems, lifestyle data, etc.
- There is also lower Capital deployment which essentially drives benefits to customer.

The growth of digital processes – notably blockchain, straight-through processing, big data, and artificial intelligence – is driving the shift to paperless trade

2.4.1 Block Chain Technology (BCT) and Trade Finance

Recently, Trade Finance (or the sleeping giant referred to above) seems to have stirred, albeit slightly, with a notable number of press releases about proof of concept projects to digitise trade finance, frequently based on distributed ledger technology (DLT), often known as blockchain or Block Chain Technology (BCT). This is the latest disruptive innovation that is primed to significantly alter the way business is done.

A blockchain allows multiple parties to transact through a single, shared, decentralized ledger, where each party witnesses the same view of that ledger, but no one party can independently control or manipulate the content therein. In what has quickly become a burgeoning field, several flavours of blockchain already exist today. Private blockchains are those confined to a single organization, operating exclusively within those bounds. Consortium blockchains are shared between multiple organizations, but with explicit onboarding required to participate. Public blockchains are those which operate on the public internet (e.g. Bitcoin, Ethereum), and are accessible by anyone wishing to participate.

Blockchains are also differentiated by the functions they support – Smart Contracts provide the ability to embed business logic & rules within ledger transactions, allowing predefined actions to be orchestrated by the contract code itself. What all blockchains have in common however, is that they are underpinned by a combination of cryptography and the means to reach consensus between all parties.

Every action is timestamped and logged independent of all other parties, and without the need for any central arbiter. Blockchains can also provide the ability and choice to protect sensitive information given the necessity of the use case application.

Consequently, it is possible to build a system which provides transparency, confidentiality, and speed of execution across multiple parties, while reducing risk, reconciliation effort and cost for all. With this capability, it is easy to see why blockchain technology continues to garner interest in a wide variety of industries.

A good example of early adopters is the Indian Banking and Financial Sector where the regulator has permitted a proof of concept to be carried out. This was specifically done using trade finance data and the results have been successful showing transparency of various events originated by different parties, immutability/tamper -evidence, and automated flow triggered by the occurrence of specific events.

2.5 Size of the Trade Finance Assets

The Bank of International Settlements (BIS) correctly notes that there is no single, comprehensive source of statistics allowing for an evaluation of the exact composition and size of trade finance markets (BIS, 2014b). However, it found that the market for trade finance, considered in its widest definition, is very large – certainly well above US\$ 12 trillion annually out of US\$ 18 trillion of exports (or imports). For bank-intermediated short-term trade finance, the BIS determined that “a flow of some US\$ 6.5-8 trillion was provided during 2011, of which around US\$ 2.8 trillion was LCs. Based on the 2011 statistics, approximately a third of global trade was supported by Bank intermediated trade products with the balance being inter-firm trade credit.

This trend has gradually altered in favor of inter-firm credit with current trends estimated at 85% inter-firm (on open account terms) and 15% Bank-intermediated (through documentary credits).

3 TRADE FINANCE IN AFRICA

3.1 The State of African Economic Performance

Trade contributes to economic growth and development through different channels. Exports allow firms to access larger markets and to innovate through greater competition, leading to higher productivity and growth. Imports expand the range of goods and services that consumers can access. In addition, imports allow firms to access machinery and intermediate goods for production purposes.

Africa’s GDP grew, on average, at 4% per annum between 2000 and 2012, declined to an average of 3.5% between 2013 and 2015 but shrunk to a decade-long low of 1.7% in 2016 driven by weak global economic conditions, still-low (even if rising) oil and commodity prices and adverse weather conditions (drought).

This decline also reflected weakening economic conditions in Africa’s largest economies in 2016—Nigeria (-1.6 per cent), South Africa (0.6 per cent) and Angola (0.8 per cent)—and growth deceleration in Algeria (2.9 per cent), Egypt (3.4 per cent) and Morocco (1.7 per cent).

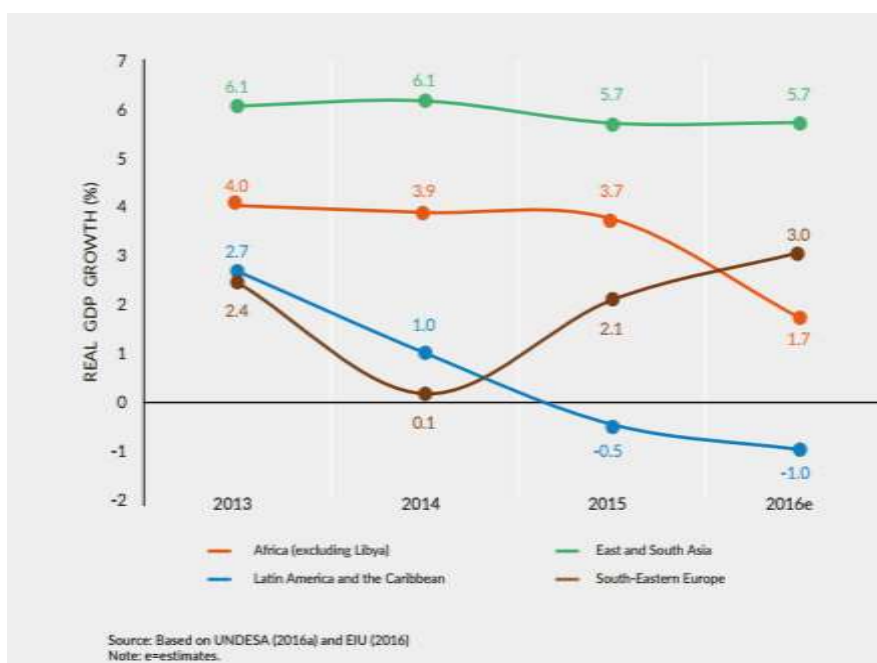


Figure 10: Economic growth in Africa and emerging and developing countries, 2013–2016

Performances diverged: Côte d’Ivoire saw 8 per cent growth in 2016, Kenya 6 per cent, Morocco 1.7 per cent and South Africa 0.6 per cent, but Nigeria recorded a 1.6 per cent contraction and Equatorial Guinea one of 4.5 per cent.

Data from the United Nations Conference on Trade and Development (UNCTAD) Trade and Development Report (TDR) 2016 shows that although exports from Africa in 2015 were worth US\$373.1 billion, this was a big decline by -39.8% since 2011 and down by -34.9% from 2014. African exports represent an estimated 2.3% of total world exports which were \$16.239 trillion during 2015.

Based on statistics from the International Monetary Fund’s World Economic Outlook Database, the total Gross Domestic Product (GDP) for African countries amounted to roughly \$5.809

trillion in 2015. Exports account for about 6.4% of Africa’s total economic output. Given Africa’s population of about 1.153 billion people, the total \$373.1 billion in 2015 African exports translates to roughly \$323 for every person on the continent.

AFRICA'S TRADING PARTNERS	AFRICAN MERCHANDISE EXPORTS BY REGION (2015)	
	US\$bn	%
AFRICA	74	19%
EUROPE	150	39%
ASIA	101	26%
NORTH AMERICA	27	7%
MIDDLE EAST	15	4%
CENTRAL & SOUTH AMERICA	10	3%
COMMONWEALTH OF INDEPENDENT STATES	2	0.5%
TOTAL WORLD EXPORTS	379	

Source: WTO

Table 4: African Merchandize Exports by Region (2015)

65% of African exports are to Europe and Asia with trade with the rest of the World being quite weak. The above table highlights the biggest weakness in the composition of Africa’s trade – that intra-African trade comprises just 19% of total African exports.

The table a leaf shows the average annual value of LCs issued by Banks in Africa split by region.

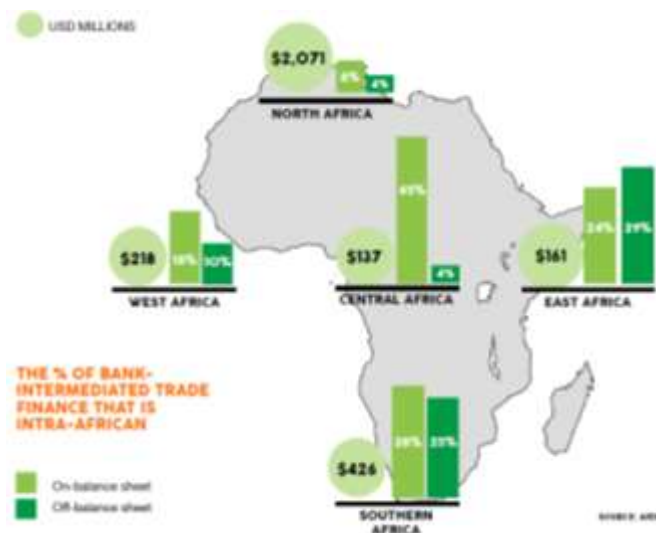


Figure 11: Average Annual Value of Letters Of Credit Issued by Banks in 2014 & 2015

3.2 State of Trade Finance

In the past decade, trade has been a major contributor to Africa's economic growth, and expanded at an average annual rate of about 8%⁶ (see fig 10 below). Despite this growth, importers and exporters are faced with the key challenge of financing cross-border trade where there is a significant lag between payments and the delivery of goods and services. This requirement for trade finance to intermediate between the exporters and importers is estimated at 360 to 400 billion, based on the comprehensive 2014 'Trade Finance in Africa' survey by AfDB. This is the most comprehensive survey to-date on trade finance in Africa.

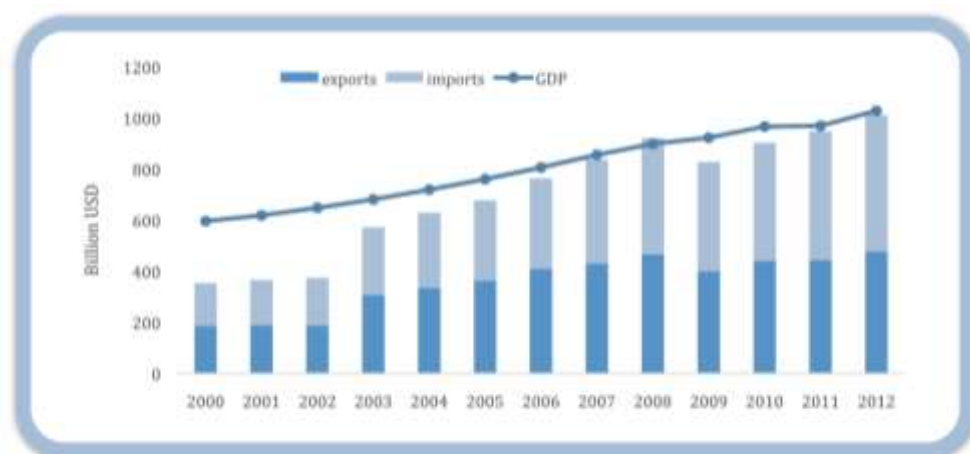


Figure 12: Trade and GDP in Africa over 2000-2012

From average values of the trade finance assets and the proportion of commercial banks engaged in trade finance activities, it is estimated that the size of bank-intermediated trade finance market on the continent amounts to approximately USD 400 billion⁷. The value of trade (sum of imports and exports) in Africa is approximately USD 1.2 trillion⁸. Whereas the estimated value of trade finance undertaken by commercial banks based on 2011/2012 data was roughly 30% (Dornel (2014), global trends seem to imply that this ratio has dropped and may be guesstimated at about 20-25%.

Furthermore, the majority of the bank-intermediate trade finance (about 68%) is made up of off-balance sheet trade finance (e.g. letters of credit), while the rest is financed with on-balance sheet instruments (e.g. short-term loans).

The above estimate is within the range found in other recent studies. BIS (2014) estimated globally bank-intermediated trade finance to range between USD 6.5 trillion to USD 8 trillion in 2011, covering about one-fifth to a third of global trade.

Within this amount, it estimated African bank intermediated trade finance to represent about 5%.

⁶ Africa Development Bank's Africa Economic Brief Series (AEB Volume 6, issue 2, 2015)

⁷ Extrapolation of data from the AfDB 2014 survey that estimated this to about USD 350 billion in 2011 and USD 330 billion in 2012.

⁸ Extrapolation of data from the AfDB 2014 survey that estimated this to was approximately USD 950 billion in 2011 and USD 1 trillion in 2012

3.3 Recent trends in Trade Finance in Africa

The Trade Finance trends in Africa are best analysed based on whether they are bank-intermediated or open account.

3.3.1 Bank-intermediated Trade Finance⁹

The following is a high-level summary of bank intermediated trade finance based on the 2014 comprehensive survey by AfDB (using 2011 and 2012 data):

- **The value of bank-intermediated trade finance in Africa is estimated to be USD 350 billion, which is roughly equal to one-third of total African trade.** There is significant sub-regional heterogeneity, with the average trade finance assets per bank in Northern Africa dwarfing those of the other sub-regions.
- Of the above amount, **the share that is devoted to intra-African trade is limited, and comprises approximately 18% (USD 68 billion) of the total trade finance assets of African banks.** Notably, the share of intra-African trade accounts for 11% (USD 110 billion) of the value of total African trade. This implies that while the value of trade finance that African banks devote to support intra-African trade is lower than the amount of the region's internal trade, the proportion is much higher than the latter's.
- **There are still significant deficits in meeting the demand for trade finance in Africa.** Given the estimated rejection/approval rates reported in the survey, the conservative estimate for the value of unmet demand for bank-intermediated trade finance is between USD 110 billion and USD 120 billion, significantly higher than estimated earlier figures of about USD 25 billion. These figures suggest that the market is significantly underserved. Unmet demand is also much higher in fragile and low-income countries (LICs) than in middle-income countries (MICs).
- **Trade finance is a relatively low-risk bank activity in Africa but not to the same degree as other regions.** Average trade finance default rates in Africa (4%), while low, are still higher than other regions of the world where it averages less than 1%. Default rates are also highly variable across sub-regions. However, the trade finance default rates are significantly lower than banks' overall non-performing loans ratio.
- The outlook for trade finance remains positive, with many banks expecting to increase their trade finance activities in the immediate future. However, banks foresee obstacles to their trade finance portfolio growth such as low US dollar liquidity, regulation compliance, slow economic growth, and the inability to assess the credit-worthiness of potential borrowers.
- Trade finance is an appealing activity for African commercial banks and is attracting a growing number of players. The majority of banks undertake trade finance activity. This high participation rate in the sector is true for all sub-regions of the continent.
- Trade finance contributes about 17% of African banks' earnings on average. Banks' share of earnings from trade finance is inversely proportional to the depth of financial markets in their home countries. Whether this adds to the diversification of banks' earnings is not clear from available data.
- The most common fee rate (on a quarterly basis) for issuing letters of credit in Africa remains virtually unchanged within the range of 0.5% to 1% between 2011 and 2012. The effects of the global financial crisis seem to be abating, at least with regards to pricing in the trade finance market. While there have been significant increases in pricing for trade finance

⁹ Adopted from the 2014 Trade in Africa report by AfDB resulting from a comprehensive primary Survey done

instruments during the financial crisis (2008-2010), the results of our survey suggest that pricing has stabilized between 2011 and 2012 in Africa.

- African banks face numerous constraints in meeting the demand for trade finance. The main constraints are limited US dollar liquidity (by far the dominant currency in international trade, and by extension, trade finance) and insufficient limits with confirming banks. Indeed, the requirement of confirmation of letters of credit (LCs) remains a major challenge for African banks as virtually all LCs issued by banks on the continent require confirmation when the counterparty is located outside the region. Given the limits on risk headroom by confirming banks for African issuing banks, a large number of the latter are highly constrained in providing needed trade finance.
- There is a growing list of African confirming banks, though most of these are located in the more developed markets of the region. In fact, the biggest determinant of the likelihood of a bank confirming letters of credit is whether it is located in a country with high GDP and financial sector development. Other factors that determine the likelihood of a bank confirming letters of credit is size (in terms of total assets) and local ownership. It is not clear to what extent African-based confirming banks can confirm letters of credit when the beneficiary of the letter of credit is located outside of the continent. Confirming banks are significantly less likely to be in low-income and fragile states.
- Given the above constraints, there exists a significant role for governments and development finance institutions (DFIs). In particular, trade facilitation programs that address USD liquidity and relax constraints from binding risk limit are needed to meet the increasing demand of African firms for trade finance. Given this reality, the AfDB's trade finance program is a welcome addition to on-going trade facilitation programs instituted by a number of DFIs.

3.3.2 Open Account Trading

From the available data, it transpires that 70% of the trade in Africa is done on open account terms. This is based on 2011/2012 figures and, based on recent global trends, this would easily have moved to about 80%.

Based on the AfDB survey, approximately 73% of the declined applicants (for bank-intermediated finance) have no alternative at all while the remaining 27% find the alternative quite expensive.

These statistics help to shed light on the importance of open account trading in Africa which includes inter-firm credit arrangements such as cash-in-advance and open account transactions. In a cash-in-advance arrangement, the importer extends credit to the exporter by making payment before the goods are transferred with transaction risk borne by the importer. In an open account transaction, the exporter bears the risk by transferring goods before full payment is received. Both mechanisms carry significant risk and firms mostly partake due to lack of alternatives.

The advent of Supply Chain Finance techniques and risk mitigation techniques such as credit insurance, allows firms now to participate in open account trading in a structured manner.

FinTechs are also making it possible for Banks, DFIs, Pension Funds and other financial entities to finance open account trade at minimal risk.

In Africa, notable FinTechs using SCF technology include Ennovative Capital (East Africa), Propell (South Africa) and Ubiq Innovations (Northern Africa).

3.4 Trade Finance Assets

Banks in Africa undertake both on-and off-balance sheet financing. The main on-balance sheet trade finance instruments are short-term loans such as pre-export loans, post-import loans and trade-related revolving credit, while the key off-balance sheet activity is the issuing of letters of credit.

Off-balance sheet operations are more commonly used, with the average annual value of off-balance sheet trade finance assets of USD 297 million in 2011 and USD 270 million in 2012. The average value of on-balance sheet trade finance assets was USD 136 million in 2011 and USD 127 million in 2012.

Both on-balance and off-balance sheet operations have declined in 2012 compared to 2011 which is consistent with the findings of the survey conducted by ICC on mostly advanced countries.

Distributed across Africa, North Africa takes the lion's share of African Trade Finance assets



Figure 13: Average Values of On and Off-Balance Sheet Trade Finance Assets by Various Categories (in million USD)

Bank-intermediated trade finance market in Africa is estimated at about USD 350 billion in 2011 and USD 330 billion in 2012 respectively. The value of African trade (sum of imports and exports) stood at approximately USD 950 billion in 2011 and USD 1 trillion in 2012, implying that Banks funded only one-third of the African trade flows in 2011 and 2012. It is estimated that this percentage has since halved. Of the funding, three quarters was funded using off-balance sheet funding with one quarter using on-balance sheet instruments. This trend is consistent with global data by BIS.

The share by African Banks of the global trade assets in 2011 and 2012 was estimated at 5%. This has since shrunk and is currently estimated at about 2%-3%.

3.5 Intra-African Trade

Intra-African trade remains quite limited. Notably, among all the regions of the world, intra-regional trade is lowest in Africa, accounting for approximately 19% of the total value of African trade in 2012 (UNCTAD 2016). For Asia, Europe and Latin America, intra-regional trade represented, on average, about 51%, 68% and 21% of their trade over the period 2007-2011, respectively.

Among all the regions of the world, intra-regional trade is lowest in Africa, accounting for approximately 19 per cent of the total value of African trade in 2015 (Table 7 above), although this is a big increase on the 11 per cent recorded in 2012 and even the 15.4 per cent recorded in 2014. This rise is partly a function of the fall in the value of African commodities to the rest of the world but is also the result of rising trade volumes between African states. Cross-border transport links are improving, with new investment in both road and rail projects. In addition, regional trade groups, such as the Southern African Development Community and East African Community are eroding trade barriers.

The share of intra-African trade is not uniform across sub-regions. North Africa has the lowest proportion of intra-regional trade mainly because of the limited integration of the 6 countries in this sub-region (5%). The sub-region with the highest proportion of intra-regional trade is Eastern Africa (27% in 2012).

Western and Southern Africa have almost similar proportions of their trade done within the region. Interestingly, this ordering of sub-regions changes when the values, instead of the proportions of intra-regional, are considered. Specifically, when expressed in US dollar values, the small proportion of intra-regional trade in North Africa surpasses the value of intra-regional trade for those of Eastern and Central Africa. Southern Africa has the largest value of intra-regional trade, almost as high as Western, Eastern and Central Africa combined.

3.5.1 Trade Finance Supporting Intra-Africa Trade

The Intra-African trade values above are considered an underestimation of trade flows among African countries since a significant amount of informal cross-border trade takes place on the continent. Yet, even if the value of informal trade were to be included, it is doubtful that the degree of intra-African trade would match that of intra-regional trade in other parts of the world. For instance, intra-regional trade in Europe and Asia, as a share of their total trade, exceeds 65% and 40% respectively.

The proportion of bank-intermediated trade finance that is dedicated to intra-African trade is roughly equal for both on-balance and off-balance sheet financing.

The average share of trade finance provided by our responding banks to support intra-African trade stood at 16.9% and 21.2% in 2011 and 2012 respectively with significant variations based on region per the following diagram:

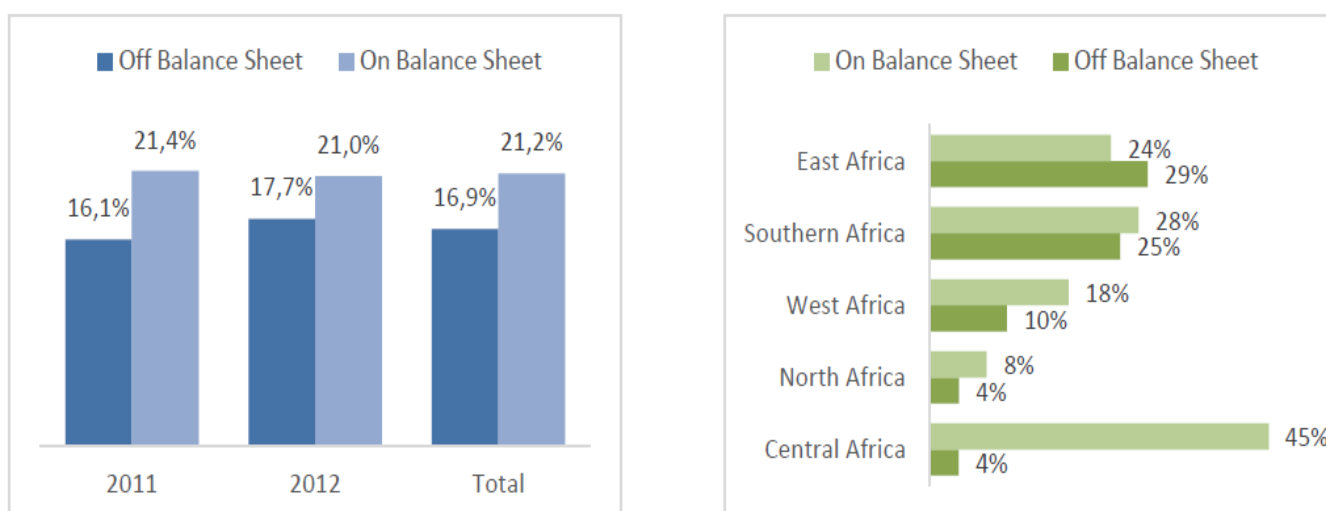


Figure 14: Average Share of Banks' On and Off-Balance Sheet Trade Finance Assets Supporting Intra-African Trade by Year and Sub-Region

North Africa shows the lowest share of financing of intra-African trade while Southern and East Africa show the highest averages.

The survey found out that the proportion of financing that banks devote to intra-African trade (17% to 21%) – while not particularly high – compares favourably with the intra-African proportion of total African trade (11%). However, the actual value of bank-intermediated intra-African trade (USD 56-73 billion) is still lower than the total value of intra-African trade (about USD 110 billion).

Further, the share of on-balance sheet intra-African trade finance is higher than the off-balance sheet, unlike the overall picture for total trade finance for African banks. It is not clear what accounts for this particular difference for trade finance dedicated to intra-African trade.

4 ACCESSING AND UTILIZING TRADE FINANCE CHALLENGES FOR CROSS BORDER TRADE

The access-to-trade-finance challenges faced by African companies are not significantly different from those identified by the global ADB survey covered elsewhere in this report.

Owing to lack of data to support, we have used the AfDB survey covering to review the reasons for rejection of on-and-off balance sheet transactions as proxy of the key challenges. These reasons reflect both supply-side and demand side challenges that should be addressed.

1) Rejection of Off-balance sheet applications

According to the survey, the top three reasons that Banks reject applications for LCs are;

- i) Client creditworthiness – which is a pointer to the limited capacity of most African banks in appraising the credit risk of their clients
- ii) Limited foreign currency liquidity (especially US Dollars since globally, about 80% of LCs are denominated in this currency)
- iii) Inadequacy of limits granted to them by confirming banks – based on the individual bank characteristics and country. It is noted that many confirming banks require cash collateral from African commercial banks to confirm LCs when limits are exhausted even though trade finance transactions are asset-backed and self-liquidating.
- iv) The size of the Bank’s balance sheet which informs the counterparty limits they can grant individual clients.

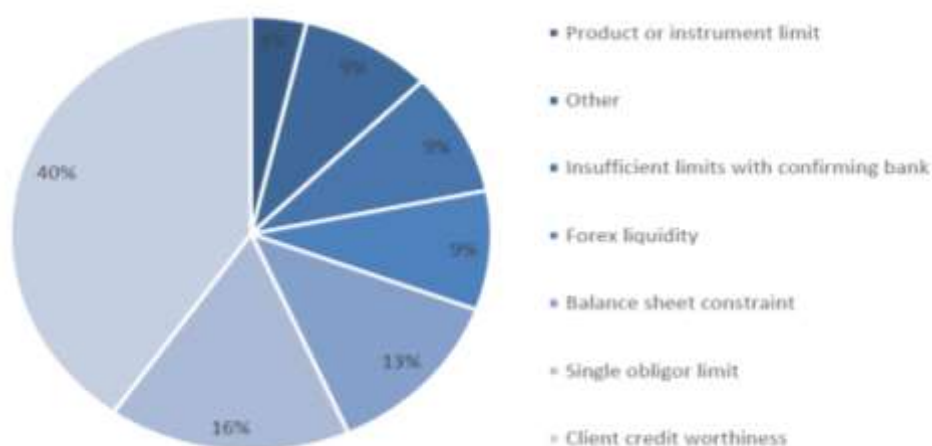


Figure 15: Reasons for Banks’ Rejection of Letter of Credit Applications

As depicted by the table below, the reasons are pretty consistent across the various regions

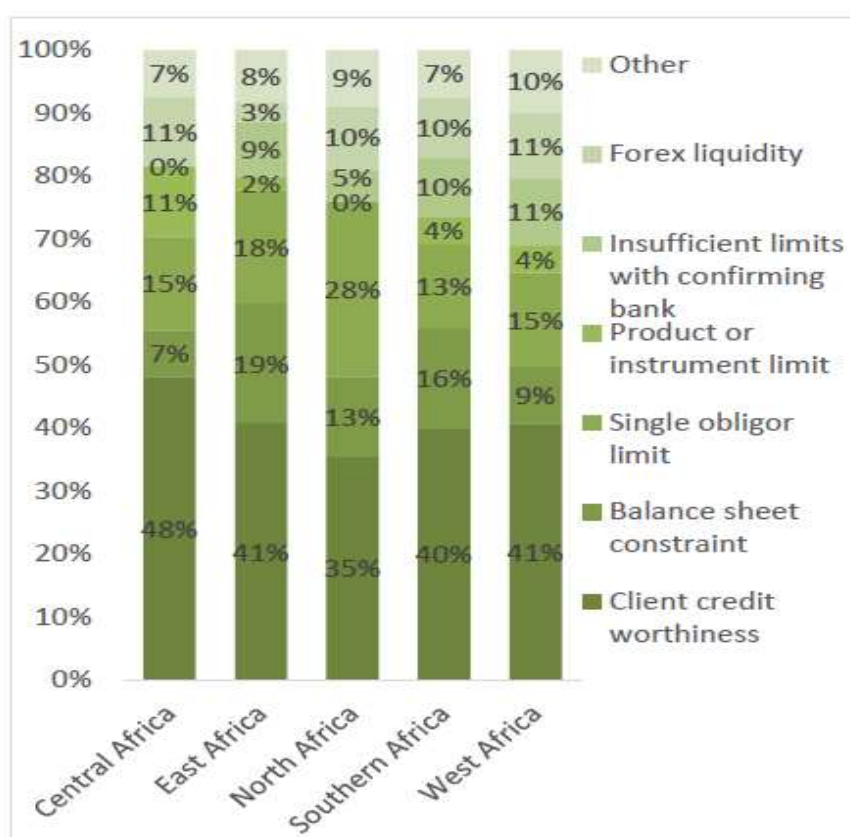


Figure 16: Reasons of Banks' Rejection of Letters of Credit Applications by region

2) Rejection of On-Balance Sheet Trade Finance applications (e.g. Short-Term Pre-Export and Post-Import Loans)

The most commonly used on-balance sheet instruments are short-term trade finance loans and trade-related revolving credits. As depicted in the table below, the average approval rate for on-balance sheet facilities for banks in our sample is 75% which implies a much higher rejection rate than off-balance sheet. It is also noteworthy that the rejection rate of trade finance loans in Africa is higher than those reported for other regions of the world (Danielson and Scott 2004). This is consistent with the well documented evidence in the literature that African firms face bigger challenges to access finance.

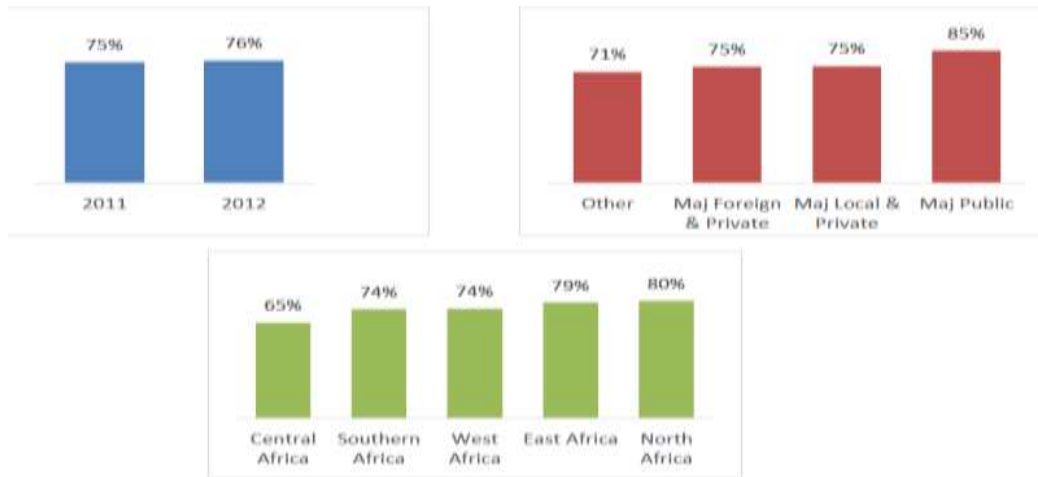


Figure 17: Average approval rate for on-balance sheet facilities

The reasons for rejection of on-balance sheet applications largely mirror those of off-balance sheet applications, including the regional distribution

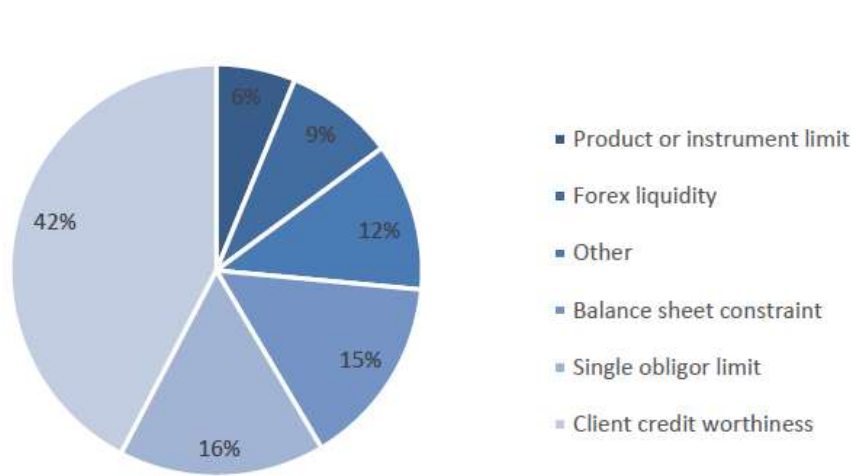


Figure 18: Reasons Bank reject on-balance sheet applications



Figure 19: Banks' Reasons for Rejecting Firms' On-Balance Sheet Trade Finance Facilities Application by region

From the foregoing, key challenges include:

1. Capacity challenges of Financial Institutions
2. Governance of the Financial System and
3. Demand-side challenges – these are consistent with the ADB global survey, particularly high cost of finance, prohibitive information requirements, and the need for collateral.

5 OPPORTUNITIES IN AFRICA FOR COMPANIES OFFERING TRADE FINANCE

The following are considered some of the opportunities that companies in Africa may take advantage of in order to mitigate the challenges encountered in accessing finance:

1) Use of Credit enhancement instruments to reduce pricing and enhance access:

A key reason cited by applicants is the cost/price of accessing trade finance. Using credit insurance from an underwriter with a strong credit rating replaces the borrower's credit risk with that of the insurer thereby reducing the pricing while guaranteeing access. Further, these instruments can insure open account trade across borders thereby accelerating intra-Africa trade without using bank-intermediated instruments.

2) Adopt latest technological Innovations

African businesses should adopt the use of technology to remove the information asymmetry, reduce risks and enhance cross border trading. Supply Chain Financing using technology has been shown to significantly enhance trade by attracting liquidity into supply chains that were hitherto viewed as risky e.g. Agriculture. This is by anchoring risks within the supply chain to the party with the strongest credit rating who also manage performance risks.

The successful large-scale deployment of Supply Chain Finance is perhaps that of NAFIN (Nacional Financiera) in Mexico. This program was used to jumpstart the Mexican economy after the Peso crisis in late 90's. The Government identified productive value chains and created chains between large buyers and SME suppliers. This success has been widely studied and is the subject of a World-Bank-sponsored case study¹⁰

Technology also includes use of mobile technology to facilitate trade. The case study of Mpesa in Kenya is a classic example which addresses access, cost and expediency. It serves both as a payment system as well as a credit system.

The newest-kid on the block – block chain – should be adopted as it has the potential to remove most of the barriers to trade via its smart contract capacity which will significantly eliminate non-value-adding intermediaries while also facilitating payments.

3) Use of Commodity exchanges

The [Ethiopia](#) and [East African Commodity exchange](#), JSE Commodity Derivatives Market, Ghana Commodities Exchange (GCX) are good examples of modern and efficient marketplaces to trade spot, forward, and futures contracts in agricultural, non-agricultural, electricity, and other derivative products. Whereas these operate regionally, technological innovations have enabled the creation of virtual exchanges that would operate across the entire continent. One such operator is [Pan African Exchange](#), a Pan-African focussed international exchange that is fully electronic and aims to facilitate price discovery and provide a trading platform between small-scale farmers, traders and processors.

Such exchanges provide hedging mechanisms that remove counter-party risk and enable financing through an electronic warehouse receipt systems, among other instruments. They provide an efficient platform for the allocation and flow of capital between issuers and investors through listing of equity and debt. PANEX has begun its inaugural operations in Zambia and is currently seeking regulatory approvals in other African jurisdictions.

10 The Role of "Reverse Factoring" in Supplier Financing of Small and Medium Sized Enterprises – Leora Klapper, Development Research Group, The World Bank

Worthy of mention is the EAGC initiative – G-Soko – that is a digital grain trading platform that is linked to a series of accredited warehouses. This is an initiative that if well-developed could also further un-lock capital to facilitate grain trading.

4) Use of Credit Reference bureaus to improve credit scores:

Introduction of credit reference bureaus as a ‘blacklist’ has marred the use of these public entities to build credit scores for African firms. It is time that people volunteered information to the bureaus so as to build their scores over time to enhance their chances of accessing credit.

5) Distribution of Trade Assets

Banks have historically engaged in secondary market sales to other banks and, less frequently, some banks have also used the trade credit insurance market to reduce risk. However, the distribution of trade finance risk to other banks is viewed as less viable against the backdrop of the changing regulatory landscape.

An “originate to distribute” model for trade loans through securitization is therefore a viable option used by Banks as it allows them to optimize on capital and/or liquidity and reduce funding needs, while preserving a return on Bank’s comparative advantage in originating and managing trade finance loans.

Securitization will create a sustainable funding structure by attracting bank and non-bank investors into trade finance. Whereas regulations may not be up to speed, some countries e.g. Kenya already have regulations permitting issuance of Asset Backed securities. Trade Receivables is one asset class that is ripe for trading and requires concerted efforts by all parties. Governments and regulators need to invest in creating public awareness to ensure that there is sufficient literacy.

Distribution to outside investors can also free up counterparty space on balance sheets and reduce trade loan concentrations. For non-bank investors, direct or indirect investment in trade finance assets could potentially offer a relatively attractive return relative to risk.

6) Opportunity to establish Trade Finance Funds

The fact that the trade finance gap is widening and it is common knowledge that Banks will not close the gap opens up the opportunity for specialized trade finance funds to facilitate intra-Africa trade. A few exist in the market e.g. the Challenger Funds out of Mauritius. There is scope for more. There is also scope for Hedge Funds to invest in trade assets.

6 CONCLUSIONS AND RECOMMENDATIONS

This report has attempted to chronicle the challenges affecting the financing of intra-Africa trade. It has attempted to benchmark with other regions to show that it is feasible to increase intra-Africa trade.

Some of the recommended actions variously captured in the body of this report include, but are not limited to:-

1) Diversify core trade financing mechanisms

Africa must diversify its core funding mechanism by creating awareness on the benefits of inter-firm credit as an integral funding mechanism (in addition to Bank, and not as a replacement of, intermediated financing). Global statistics show that the share of bank-intermediated trade Vs open account trade has altered in favour of the latter (85:15). Indeed in some statistics, it is estimated that the ration is in the 90:10 region and moving. Granted, the adoption of open account terms opens up new risks which must be dealt with imminently to maintain the integrity of the system, notably payment risk as well as inordinately long credit terms by large corporates against the predominantly SME suppliers. To mitigate payment risk, credit insurance and guarantee schemes come into effect. Africa Trade Insurance, Coface, and Euler-Hermes exist in Africa but each covers a very limited jurisdiction. There is need to facilitate these agencies to cover the entire continent so as to make open trade seamless. Further, capitalization should be reviewed to ensure that they have capacity. Africa Trade Insurance, for instance, at times turns down requests for cover on the grounds of exhausting a counterparty limit – e.g. of a corporate or a specific government.

With regards to unfavourable terms against SME suppliers, Africa should take cue from various Governments the world over – including the US, UK, Netherlands, France, Australia, etc. – who have put in place mechanisms that ensure suppliers are not overly exploited. This requires legislation to limit the credit days but also permit use of technological innovations to enable suppliers to access their funding early.

2) Adopt Large-Scale Supply Chain Financing

One technological innovation used globally to facilitate early access to working capital for SME suppliers is technology-driven Supply Chain Financing. The well-documented case study of NAFIN in Mexico shows how supply chain finance can have a significant impact on a country's economic development. This structure helps to remove information asymmetry and risks as well as improve efficiencies across borders and thereby attract finance for trades. SCF has been around for over a decade but very few countries in Africa have adopted this as an acceptable structured form of trade finance. This is not peculiar to Africa as Duval et al., 2014 confirmed through a global survey that despite SCF being confirmed as the most likely form of financing to increase SME exports, there is very limited awareness of this financing mechanism. SCF has the innate capability to replace the burden SMEs and African Banks go through to establish LCs (with all their attendant costs). SCF has the capacity to attract funding from the Financial Services Industry including banks and non-bank actors like pension funds, etc. At the advanced level, SCF can create a secondary market for receivables, thereby attracting capital markets funding as well as crowdfunding to finance trade. For this to happen, regulators need to fully review and put in place sufficient mechanisms to facilitate these innovations. The Kenya Capital Markets Authority (CMA) is one of the few regulators in Africa that has gone ahead of the market to develop a law for Asset Backed Securities allowing market players the opportunity to issue trade receivables-backed assets to investors.

3) Regulators to invest in Innovation

Regulators to form innovation departments staffed with qualified technology and finance professionals to advise on how to regulate the emerging technologies. A good example was the MPesa revolution in Kenya which in its formative years received negative regulatory support. It however, exploded in an unregulated fashion and thus created a nightmare for the regulator as it now transcends financial services, telecommunications, technology, and media. The newest kid on the block - Block Chain – is touted to be the next big thing after the internet. Some African regulatory regimes have flatly refused to engage with the industry in order to understand how this new innovation could help the industry. Borrowing a leaf from the Indian Financial services regulator would be a good idea – form a multi-stakeholder working group and pilot the innovation before taking any step. The merits of BCT have been enumerated elsewhere in this report.

4) Large-Scale Demand-side Awareness programs

The level of awareness on the demand side of the trade finance instruments available in the market is very low. There is need to put in place cross-cutting programs to create awareness in the market on the various instruments available in the market and their benefits by Governments. A partnership with regulators and private sector stakeholders (e.g. apex membership bodies like EAGC, African Cotton Association, etc.) would help to reach critical mass.

5) Regulatory collaboration

For intra-Africa trade to flourish, the regulatory regime across the continent needs harmonization within the Basel framework. This will ensure that Banks that have a ‘home’ regulator face less onerous requirements from the ‘host’ regulator.

6) MDBs and DFIs to collaborate and partner

There are many initiatives offered by MDBs and DFIs – IFC, AfDB, AfreximBank, the nascent Africa Investment Bank, regional DFIs like East African Development Bank, etc. However, these financial institutions, all with a developmental mandate, appear to operate like competitors. Despite their innate need to have a triple-bottom line objective, their cost and structure of finance, risk mitigation instruments used, duration taken to assess risks, documentation processes, and other internal processes do not endear them to customers. Were they to collaborate, funding that currently is spent by each entity to assess credit would be dedicated to developing large databases of businesses across the continent and facilitation of credit rating affordably for these companies. Further, investment preparation facilities could be sent up centrally to originate credit applications as opposed to each entity using a large team to assess credit across the continent. There is need for closer collaboration and harmonization of the solutions to ensure maximum benefits for all across the continent.

7) Reduce currency exposure to facilitate intra-Africa trade

The AFREXIM Bank has an Africa-wide trade financing mandate and therefore has the greatest opportunity to facilitate greater intra-Africa trading. The Bank should establish local currency financing products to remove the currency risk that factors and banks borrowing from it have to shoulder (and pass on to their clients). This would be achieved working with the donor community akin to the manner in which KFW facilitated the establishment of the [Africa Local Currency Bond Fund](#). Further, in addition to factoring, AfreximBank should add diversity to its trade financing portfolio to include Supply Chain Financing which is well discussed in this report.

8) Local Initiatives by individual RECs and Member States

RECs and Member States to establish strong and well-funded finance institutions including cross border micro credit programs for producers and exporters. Many countries, for instance, do not have an ECA and rely on the continental ECAs.

9) Incentives to attract financing for Trade Assets

Member States and Banks to encourage existing banking and financial intermediaries to promote in their portfolios issues such as export finance in terms of pre-shipment and post-shipment finance needs and import loans through incentives, e.g. tax.

ANNEX I: TYPICAL TRADE FINANCE PRODUCTS

BIS lists the following are typical Trade Finance (Bank intermediated) products used globally

- **LCs** – Used to guarantee payment to the exporter and delivery and performance to the importer. Credit worthiness of importer’s bank replaces credit risk of importer.
- **Documentary Collections:** Exporter entrusts his bank with collection of payment. His Bank collects through importers bank. Documentary Credit (L/C) and Documentary Collection traffic has shown a largely flat to downward trendline for numerous years, and the latest numbers from SWIFT confirms this trend for the 2017 ICC Trade Finance Survey report.
- **Pre-export Finance:** Working capital to support production secured by title to the finished goods with payment received from importers directly.
- **Supplier credit:** Working capital to support exporter’s debtors.
- **Receivables Discounting:** True Purchase of exporter’s receivables at a discount and assuming credit risk of importer.
- **Forfaiting:** Receivables discounting involving medium term receivables (capital goods or commodities with longer tenors).
- **Import and export loans:** May be linked to an LC or not. Advances to importers/exporters on presentation of appropriate documentation.
- **Supply Chain Finance:** a relatively new and expanding business area combining technology and services to facilitate processing and financing of payables and receivables within a global supply chain. The supply chains are typically anchored around the global purchases and sales of a major retailing or manufacturing firm. The financial services within the SCF platform may involve many elements of traditional trade finance (e.g. pre-shipment or post-shipment finance, receivables purchases or discounting), with the notable exception of letters of credit. Attractions for participants include the possibility of optimizing payment and financing terms to suppliers and improving working capital both for suppliers and sellers. Bank credit risk is anchored on the buyer who has a better credit rating and gives payment commitment. Pricing for supplier is therefore reduced to that of the buyer giving room for interest arbitrage. According to data from ICC and SWIFT, most of cross-border today is conducted on open account terms and therefore enabled through such techniques as Supply Chain Finance.
- **Bank Payment Obligation:** an irrevocable undertaking given from an importer's bank to an exporter's bank, to pay a specified amount on an agreed future date conditional upon successful matching of electronic data according to an industry-wide set of rules adopted by ICC (ICC URBPO 750).
- **Trade Credit Insurance:** The structure of products in trade finance are geared towards reducing the payment risk. Exporters and financial intermediaries engaged in trade finance can also mitigate the risk of non-payment by using export credit insurance provided by public export credit agencies (ECAs) or private insurance firms.

In addition to the Bank-intermediated trade finance products, **inter-company credit** i.e. credit is directly accorded by the buyer to the seller (“buyer’s credit”), or inversely by the seller to the buyer (“seller’s credit”), depending on the financial capacity of either party is commonly used globally.

However, in reality, the existence of large “eco-systems” of supply chain relationships makes global trade transactions quite complex. In such supply chains, the ability of firms (i.e. large suppliers) to extend credit to their trading counterparties (buyers) is enhanced by opportunities to discount their receivables (receiving cash immediately against documentation such as the export contract), or to mitigate payment risk by purchasing trade credit insurance. Long-standing relationships between buyers and sellers may lead the two parties to choose to settle transactions on “open account”, meaning that the credit for delayed payment is automatically granted by one or the other party.

ANNEX I: LIMITATIONS AND CHALLENGES

The following were some of the key challenges encountered: -

Time Limitation: The time allocated to the assignment was quite restrictive particularly to allow for interviews with stakeholders – most of who are busy executives and can only do interviews based on their schedules. Upon consultation with EATHI, it was agreed that the key informant interviews be dispensed with.

Data Challenge: This report information herewith is fully based on literature review. Literature on Africa is scanty and more often dated.

Further, available data is on the supply side with little, if any, information on the demand side.

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