PROCEEDINGS

Overcoming Trade Finance Challenges for SMEs in Africa

Moderator: David Ashiagbor, Coordinator, Making Finance Work for Africa (MFW4A)
Panelist 1: Thierry Kangoye, Senior Research Economist, African Development Bank (AfDB)
Panelist 2: Ruediger Geis, Head, Trade Affairs, Commerzbank AG
Panelist 3: Catherine Busaule, Trade Finance Specialist, Ecobank Transnational Incorporated (ETI)
Panelist 4: Susan Situma, Head of SME Business, Barclays Bank, Kenya

Executive Summary

Trade Finance can be described as the provision of finance and services by Financial Institutions for the movement of goods and services between two points, either within a country or cross border.[1] Trade finance is a core business activity for commercial banks in Africa, as it continues to be relatively low-risk. However, due to the credibility risks and connectivity limitations, a significant trade finance gap persists in Africa. This is in contrast to middle-income and high-income countries, where there is a narrower gap in terms of trade finance.

Although SMEs are a huge growth engine for the financial and private sectors in Africa, a disproportionate share of the available financing is provided to large corporations at the expense of SMEs. Indeed, SMEs comprise more than 80 percent of all businesses in Africa. Also, significant regional differences exist in the share of total assets devoted to trade finance.

First time applicants face significant challenges in accessing trade finance facilities from banks because banks tend to favor big corporations. Thus, there is a need for better financial infrastructure, including credit information systems, to de-risk transactions and enhance banks' ability to supply trade finance in Africa.

Trade Finance in Africa

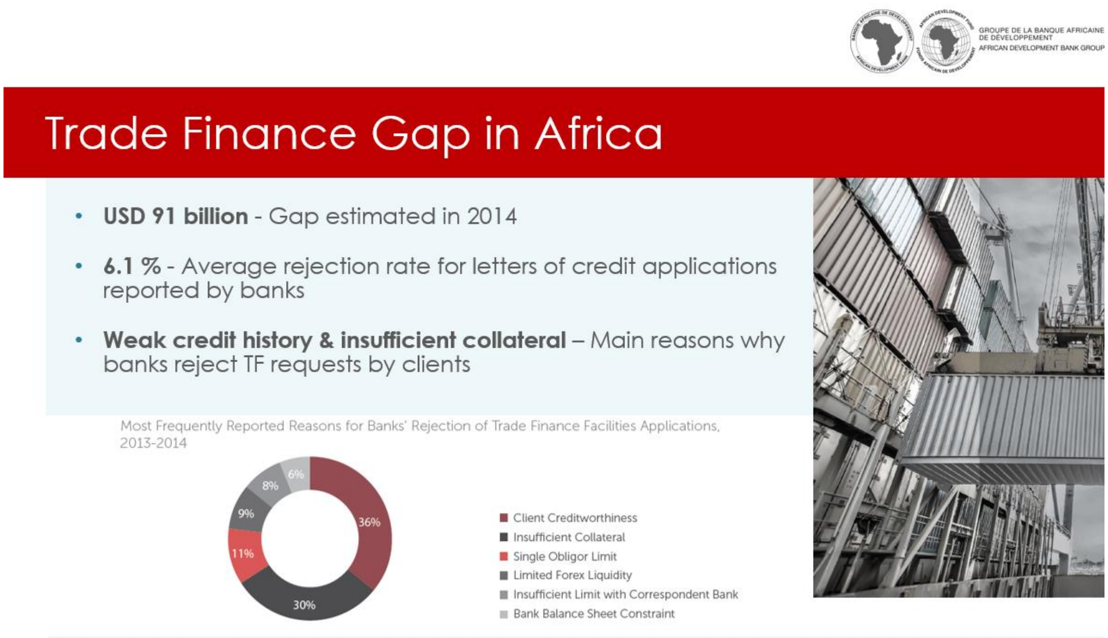
- Trade finance, by definition, is the term used for the department of a commercial or investment bank where trade transactions (either cross border and domestic) are financed. Financing is usually between a supplier and an end buyer, with the occasional involvement of a trader.

[1] The Wolfsberg Group, ICC and BAFT. "Trade Finance Principles." (2017). http://www.baft.org/docs/default-source/policy-department-documents/final-clean-trade-finance-principles-final.pdf?sfvrsn=2.

- Trade finance is a core business activity for commercial banks in Africa. In 2014, 87 percent of Africa's commercial banks were offering trade finance. However, African trade finance markets are also subject to outside influences, such as the debt crisis in Europe and the slowdown in China's economy.
- Interestingly, trade finance is quite profitable and entails less business risk for African banks. For example, trade finance activities comprised 15 percent of the total income for commercial banks in 2014. Trade finance is relatively insensitive to macroeconomic challenges, such as foreign exchange risks, thus making it especially attractive to various cooperates.

Trade Finance Challenges in Africa

- The African Development Bank estimated that the trade finance gap in Africa is USD 91 billion based on a survey of commercial banks from 49 countries in Africa. However, the gap is probably larger. It is difficult to assess the size of the trade finance gap in Africa, mainly because banks do not have a common definition of trade finance. They are also reluctant to fully disclose their trade finance portfolios. For example, the survey contacted more than 900 commercial banks, but less than a third responded. Moreover, the level of rejection rates for lines of credit is quite high for low-income and conflict-affected countries, as well as for fragile states because they tend to have more embedded financial assistance.



Source: African Development Bank Group.

- Two major reasons account for the gap in trade finance. According to the African Development Bank's survey, the first is weak credit histories, which makes it more difficult for banks to appraise the credit risk of their clients. Sometimes, applications can also be rejected because of insufficient collateral, which is second most reported reason for rejection.
- Most SMEs have very little collateral, mostly consisting of cash (10-15 percent) and limited assets. De-risking on the collateral side can be done through finance-sharing programs.
- One of the challenges in the know your customer (KYC) process are the high costs associated with it, that can be reduced with automation. Know your business (KYB) and know your authorities (KYA) are crucial steps that facilitate a proper KYC process.
- A lot of African SMEs are usually quite reluctant to disclose the full nature of their

businesses and ownership structures, which makes it difficult for banks to do an appropriate KYC, a pre-requisite for providing trade finance

- The issue of lack of liquidity is more manageable in low-income countries than in more developed ones. For example, Liberia tends to report more liquidity in trade finance. Banks in more developed countries have more competition simply because of the large number of corporations and tend to face more financial restrictions.
- Intra-African trade received limited finance mostly because the relatively developed African countries do not trade much with each other. The total amount of intra-African trade is only 15 percent of the total trajectory in Africa, compared with 63 percent in Europe and 50 percent in North America.
- Although access to trade finance is critical for SMEs to expand and intensify their international trade activities, it is often difficult to obtain. Moreover, there is a concentration of trade finance portfolios among the top clients of the banks. SME trade finance proposals are rejected at a relatively high percentage rate, whereas large corporates find it easier to have their trade finance proposals approved.
- The default rate for SMEs in African trade finance remains quite high, with approximately 40 percent of the full-time trade finance customers resulting in defaults. However, some countries in West and Central Africa have lower default rates because they have more relationship-based than transaction-based lending.
- SMEs in Africa normally have poor access to trade finance assets. Trade finance is highly concentrated among large corporates, with limited exposure to new market entrants. Hence, there is a consistent pattern of high concentration of trade finance assets among top clients, leaving limited options for SMEs.
- There are significant regional differences in the share of total assets devoted to trade finance. West Africa has a significant exposure to trade finance, whereas banks in North and Southern Africa record lower trade finance exposure. This could reflect a more developed financial sector, with banks in North and Southern Africa holding a more diversified portfolio of assets under a wider range of banking activities.
- Risks for trade finance in Africa fall into two categories. First, exposure to adverse government actions (expropriation, embargo) or instability (war, crime) is a major political risk for banks. Second, a wide variety of economic risks, such as sovereign risk, weak credit histories of importers and/or exporters, and inability to fulfill payment obligations, are also a source of concern for banks engaged in trade finance.
- Regarding de-risking between banks, on average, a country is financed or served by 16 correspondent banks. However, 45 percent of all banks in the country would probably say they only have two correspondents, and in some countries, there are no correspondents left.

The Way Forward

- Education of customers and banks is necessary for the development of trade finance. It is important for customers to find their appropriate identities, as it would certainly be beneficial to their future business development. At the same time, training staff in commercial banks is essential. Various cases have shown that many new employees in African banks are not equipped with knowledge of some basic aspects, such as country regulations and taxation.
- It is necessary to see the two sides of the coin of trade finance. On the one hand, it is easy since there are no issues with correspondent banks or compliance with western standards, and the risks are relatively low. On the other hand, it is difficult to promote trade finance because it usually entails smaller transactions and more frequent purchases. Also, the lack of a unified foreign currency exchange system across Africa makes it difficult to conduct cross-border financial activities.
- Trade finance has been found to be more promising in Africa’s coastal areas. Due to the poor conditions of transportation from, for instance, Kenya to Uganda, banks are often reluctant to provide financial support. However, transportation is more developed

in East Africa, with ports linking Kenya to Tanzania.