

A review of the trade finance landscape in East Africa and the Horn of Africa:

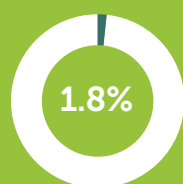
Barriers, opportunities and
potential interventions to
drive uptake

Executive summary

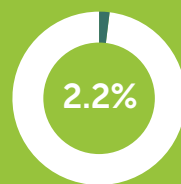
Introduction

By accelerating trade in goods and services both within the continent and between Africa and world markets, African economies have the potential to unlock transformational growth.

Africa currently accounts for:



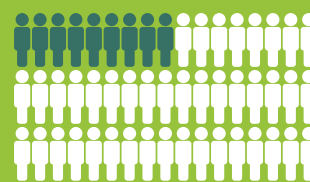
of global
trade exports



of global
trade imports

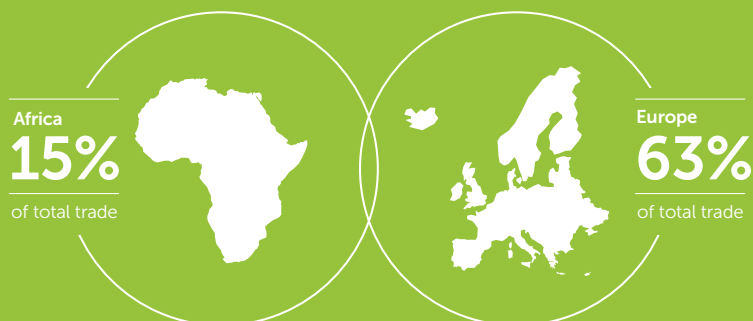


Despite comprising:



17% of the global
population

Intra-regional trade Africa vs Europe:



The low intra-regional trade in Africa is because trading activities across the continent are inhibited – for SMEs in particular – by a combination of:



Limited access
to trade finance



High export
costs*



Political
instability



Poor
infrastructure

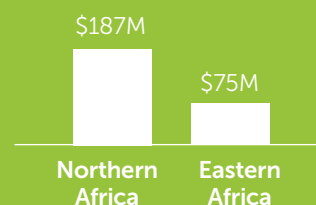


High
taxes

*(Sub-Saharan Africa has the highest export costs globally)

Regional variation in trade volumes:

Northern Africa has the highest annual export trade value of any region, while Eastern Africa has the lowest. But for all sectors and geographies, limited access to trade finance is a truly critical bottleneck to growing trade volumes.



This report therefore focuses on the trade finance bottleneck in East Africa and the Horn of Africa, applying a sector focus on agriculture, construction and textiles and garments in order to examine demand and supply-side constraints, and identify opportunities to drive uptake.

Trade finance products

Trade finance products can broadly be grouped into five categories.



Documentary trade finance



Structured commodity finance



Trade credit insurance (TCI)



Supply chain finance



Export and credit agency (ECA) finance



1

Documentary trade finance, a collective term used for traditional trade finance instruments that leverage letters of credit (LCs), guarantees and documentary collections. Given their internationally accepted status, LCs have historically been commonly used in East Africa, though there has been an increasing shift towards less traditional trade finance solutions like open account trade terms, mainly attributable to reducing risk appetite for African bank obligations.



2

Structured commodity finance, which leverages the underlying cashflows of an asset, commodity or commercial off-take contract as security in providing a financing solution (examples include warehouse receipt financing or revolving credit facilities).



3

Trade credit insurance (TCI), used in the event of credit risks such as bankruptcy or default, and **political risk insurance (PRI)**, used in the event of unforeseeable political circumstances.



4

Supply chain finance, comprising either receivables purchase solutions (allowing supply chain parties to sell against all or part of their receivables) or loan-based solutions (whereby loans and advances are made against receivables). Usage of these instruments has been low historically, primarily due to high country risk perception.



5

Export and credit agency (ECA) finance, which includes guarantees, loans and political and trade credit insurance provided by ECAs to promote exports by removing the uncertainty around export payments. ECA finance is, however, impeded by factors such as the limited availability of information needed for due diligence on SMEs in East Africa.

Across all five of these categories, product-specific issues – such as currency mismatches, limited supply of trade insurance, and cumbersome processes – also curtail usage.

Sectoral barriers to trade finance

Barriers to uptake exist at both ecosystem and trade finance provision level, emphasizing the importance of holistic interventions.

As the wide-ranging examples cited in this report show, barriers to uptake exist at both ecosystem and trade finance provision level, emphasizing the importance of holistic interventions. In the agriculture sector, inhibiting factors revolve around the high collateral requirements and pricing that result from high-risk perception, in addition to a lack of both trade finance instruments tailored to agriculture SMEs (such as supplier finance, factoring and forfaiting) and tailored risk mitigation instruments like agri-insurance and guarantees (important to pre-shipment finance in particular).

In the construction industry, limited awareness of available trade financing options is a key issue, as are the stringent trade finance terms facing SMEs – such as high interest rates, short loan tenors and the lack of interest-only options. Delayed payments from government clients – a key client segment for construction firms – also undermine the use of receivable-based supply chain finance solutions.

Finally, in textiles and garments, bank's preference for traditional collateral disadvantages the sector's provision of used machinery as collateral, which is valued lower. Limited availability - or awareness of - trade finance instruments tailored to textiles and garments SMEs, such as inputs financing and purchase order financing, also represents a barrier.

Meanwhile, across all three sectors, COVID-19 has exacerbated the challenges faced by SMEs, further widening the trade finance gap.

Against this challenging backdrop, a combined – and well sequenced – focus on demand, supply and ecosystem intervention themes is needed in order to sustainably boost regional trade finance in Africa. In addition to interventions on the demand side to help companies attract trade finance, and supply side interventions to ensure Financial Services Providers (FSPs) are providing tailored trade finance solutions to meet sector-specific needs, there is also a wider need to create an enabling environment which meaningfully supports the use of trade finance instruments.



Trade finance solutions and intervention opportunity areas



Trade finance risk mitigation

A first key focus area for intervention opportunities is trade finance risk mitigation, including the promotion of greater collaboration between public and private trade credit insurance and PRI providers through co-insurance and re-insurance; providing capacity building support for FSPs and SMEs to better understand the technicalities of insurance; extending the PRI market to provide insurance to local (not just foreign) investors; and scaling-up the provision of risk-mitigating tools and facilities such as guarantees in order to reduce high country risk perception, boost FSPs' willingness to invest, and incentivize further use of documentary trade finance solutions like LCs.



Technology solutions

Technology solutions represent a further priority area to help drive uptake of trade finance in East Africa. Intervention opportunities include: partnering with relevant organizations such as regional blockchain associations to sensitize FSPs and SMEs on existing DTL solutions that address information asymmetries between FSPs and SMEs, thereby reducing the operational costs associated with providing trade finance solutions; providing financial support to local technology providers to enable them to work with cloud providers to design local, cloud-based DLT as a way of addressing the high implementation costs of DLTs; and – finally – providing fintechs and 'tradetechs' with the financial support needed to replicate solutions like the SWIFT MT 798 tailored to the operating realities of SMEs in East Africa. This will serve to enhance FSP-SME interlinkages and promote trade automation and greater 'pooling' of trade finance requirements.



Regulatory reform

A third focus area is regulatory reform. Here, key opportunities lie in policy harmonization through mutual establishment of regional standards and capacity building initiatives to increase the implementation capacity of enforcement agencies; developing enabling legal frameworks for uptake of trade finance instruments such as factoring and warehouse receipts; addressing compliance challenges relating to KYC and AML, for example by applying a risk-based approach through a tiered system; and resolving forex liquidity challenges through the design and implementation of policy reforms that facilitate a more flexible FX regime.



Improvement of trade infrastructure

A fourth intervention area, improvement of trade infrastructure, holds significant potential. We identify opportunities to invest in storage facilities such as warehouses and cold storage, leveraging market intelligence to determine strategic placement of these facilities as measures to increase use of structured commodity finance; in addition to scaling-up commodity exchanges for aggregation of farmer produce, access to collective financing and trading of warehouse receipts. Opportunities also exist to develop alternative trade corridors to improve seamless logistics movement across countries and lower costs for exporters; as well as to provide targeted TA to banks to help deepen understanding of the value proposition on trade finance for SMEs.



Enhancing SME's competitive advantage

Finally, we see enhancing SME's competitive advantage as a critical intervention area. This may include training and capacity building programs to enhance SME competitive advantage (for example, corporate governance, marketing and book-keeping), and designing internal operating systems and processes; or leveraging cooperatives and industry associations to address weak market linkages. Additional opportunities exist in identifying competitive value chains (for instance, in agriculture, there is a need to veer away from perishable goods to processed value chains); improving access to digital-driven services and international cooperatives; and boosting quality standards for increased trade.

Opportunities

Common to each of these trade finance intervention opportunities is the need for stakeholders to view identified barriers holistically, first addressing the broader ecosystem challenges undermining the growth of trade finance, and then focusing in on the individual trade finance provision level barriers.

With this 'joined up' and well-sequenced approach, the potential to deliver meaningful and sustainable impact in this pivotal component of Africa's trade landscape is high.

Moving from thematic to sector-specific intervention opportunities, we identify opportunities to:



Leverage revolving guarantee facilities and warehouse receipt systems in agriculture



Mitigate trade finance risk in the construction sector



Enhance the scale of factoring solutions in the textiles and garments industry

In agriculture, a regional revolving fund could be used to support SME exporters by leveraging industry associations as key lobbyists and administrators to negotiate cheaper prices and guarantee payment for airline freight charges for exports. Development partners could also provide financial backing (to support industry associations and draw up the criteria for SME exporters to access the fund), or technical support to regulators to help draft legislation allowing warehouse receipts to be traded as negotiable instruments. There would also be a key role for DFIs (including multilaterals) to step in and play the role of the bank in receivables backed finance schemes by providing funds directly to exporters in exchange for the assignment of future receivables, thereby proving the value proposition and helping to crowd in more commercial trade financing.

In construction, opportunities exist for development partners to de-risk risks. Multilateral development banks can, for example, provide minimum revenue guarantees (MRGs) to local construction firms, which guarantees them sufficient revenue to cover their debt payments at a minimum. Development partners can further support in the creation of a guarantee fund which helps back MRG commitments. Technical support is required for fund set-up, in addition to financial support through capital injections into the fund. Development partners such as multilateral development banks (MDBs) could also provide partial risk guarantee facilities to cover government payment obligations and boost investor confidence in the sector.

Finally, in textiles and garments, there is an opportunity to support bank partnerships with intermediaries who can process reverse factoring transactions in order to have large uptake. Fintech partners are needed to provide the online platform through which SME suppliers can trade their invoices. Using technology facilitates the simultaneous processing of hundreds of invoices at low cost, which is key as large volumes are needed for reverse factoring to be commercially viable for banks.

Tailored financing facilities to address the specific concerns of textile and garment SMEs are also important. A collateral free-facility, similar to the recently launched Indian example, with inclusion of a slightly longer tenor (4 years, for example) as well as a one-year moratorium on principal repayments, would greatly enhance SME capacity to navigate the immediate challenges posed by cashflow constraints.

Opportunities for interventions by stakeholder type



Development partners

Development partners play a critical role in creating the broader enabling environment and holistic ecosystem needed to support sustainable longer-term growth of trade finance. Specific opportunities exist for development partners in several areas including provision of dynamic risk-mitigation solutions tailored to the study sectors (e.g., revolving funds, risk guarantee facilities) critical especially during the COVID-19 pandemic, supporting regulators in developing and adopting policy frameworks for trade finance products (e.g., factoring laws which are largely lacking in the study geographies) and providing financial support to FSPs to adopt technology innovations such as electronic documented solutions and Distributed Ledger Technologies, given the high cost of adoption.



Financial service providers

Financial Service Providers (FSPs) play an important role in providing the capital and other financial services that SMEs need to scale their trade activities. The report calls out product specific technology innovations that FSPs can consider in order to enhance the affordability and efficiency of service provision to SMEs (e.g., through collaboration between bank and non-bank service providers i.e., fintegration). The report also calls out sector-specific opportunities for FSPs to tailor instruments provided to help them meet SMEs needs better, such as provision of rolling facilities, to cater for production cycles for agricultural SMEs, and import cycles for construction and textiles SMEs.



Regulators

Regulators play a pivotal role in creating the broader enabling environment and holistic ecosystem needed to support sustainable longer-term growth of trade finance. Specific opportunities exist for regulators and policymakers in several areas including policy harmonization efforts, developing legal frameworks to support innovation and fintechs, addressing compliance challenges and forex liquidity gaps. Various country-specific intervention opportunities are also called out in the report, with one of the key opportunities being developing the supporting infrastructure and policy framework to develop warehouse financing.



SMEs

The report identifies opportunities for SMEs to improve their competitiveness in order to increase their eligibility for trade finance products as well as highlighting examples of technical assistance programs that SMEs can participate in to enhance their competitiveness including, support in identifying competitive value chains, designing internal operating systems and processes, and improving access to digital-driven services.



Other players

Other players such as industry associations play a critical role in creating the broader enabling environment and holistic ecosystem needed to support sustainable longer-term growth of trade finance. Specific opportunities exist for these players in several areas including enhancing linkages to regional and international export markets, sensitizing SMEs on existing trade finance products and how they work as well as compliance with sector standards, and collecting the market intelligence needed to better understand SMEs' country- and sector-specific trade finance needs

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