TRADE FINANCE IN AFRICA:

TRENDS OVER THE PAST DECADE AND OPPORTUNITIES AHEAD

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TRENDS OVER THE PAST DECADE AND OPPORTUNITIES AHEAD

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Acronyms

ADBI	Asian Development Bank Institute
AfDB	African Development Bank
AFCFTA	African Continental Free Trade Area
AFREXIMBANK	African Export Import Bank
AFTRAF	African Export Import Bank Trade Facilitation Program
AML	Anti-Money laundering
BNY	Bank of New York
DFI	Development Finance Institution
GDP	Gross Domestic Product
ICC	International Chamber of Commerce
IFC	International Finance Corporation
KYC	Know Your Customer
LC	Letter of Credit
NPLs	Non-Performing Loans
RPA	Risk Participation Agreement
SMEs	Small and Medium-Size Enterprises
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TFF	Trade Finance Fund
TFI	Trade Finance Initiative
TFP	Trade Finance Program
USD	United States Dollar
WTO	World Trade Organization

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Foreword

Trade is one of the most important drivers of economic growth. However, Africa as a continent is still not capturing fully trade's growth-enhancing benefits. Although its population has more than tripled over the last five decades to account for around 17 percent of the world's population, Africa's share of global trade has decreased steadily over the same period, from 4.4 percent to 3 percent. Furthermore, Africa's trade is characterized by limited intraregional activity compared to other continents. While the constraints created by infrastructure deficits as well as tariff and non-tariff barriers are well documented, supply-side constraints and financing gaps have also curtailed the expansion of both extra- and intra-African trade.

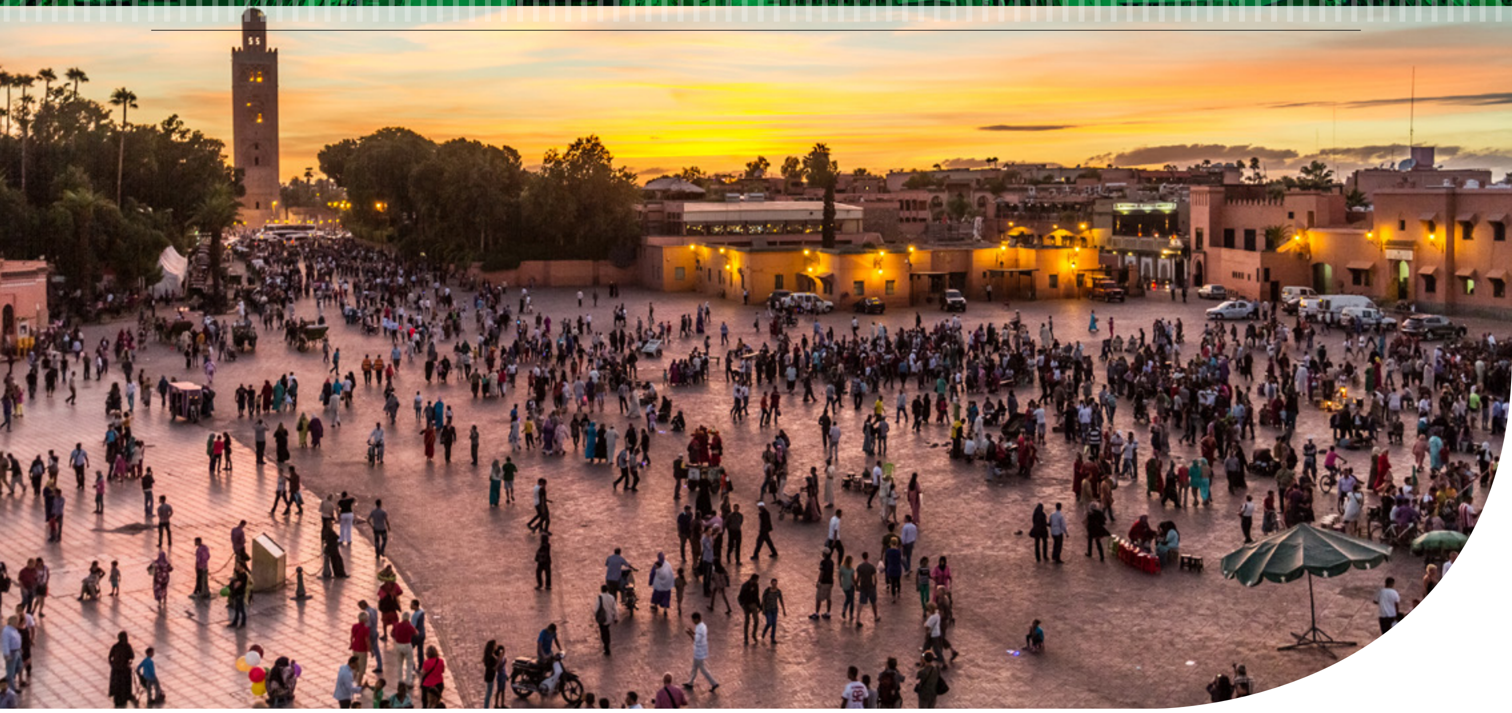
This report, the third in the "Trade Finance in Africa" research series, sheds light on the trade finance landscape in Africa. The deficit of trade finance is a persistent issue that the COVID-19 pandemic is likely to exacerbate. The African Development Bank (AfDB) and African Export-Import Bank (Afreximbank), recognizing the importance of access to trade finance for businesses, have been intervening directly in the market to address the shortfall in commercial bank financing for trade.

The AfDB launched the Trade Finance Initiative (TFI) in 2009 and the fully-fledged Trade Finance Program (TFP) in 2013. TFP has seen 53 projects approved across 324 financial institutions in 44 African countries, with USD8 billion in underlying trade flows supported. As the trade finance bank for Africa, Afreximbank has been engaged in the financing of trade since its inception in 1993. By December 2019, it had approved more than USD81 billion in furtherance of this mandate. In 2018, Afreximbank launched its African Trade Facilitation Program (AFTRAF) with a view to further enhance its trade finance intermediation. AFTRAF comprises a network of 350 banks and more than 120 credit facilities amounting to USD2.2 billion, spanning across 32 African countries.

Success in ongoing efforts by these two institutions to alleviate trade finance constraints hinges on a better understanding of the dynamics of Africa's trade finance market. As two of the continent's premier development finance institutions (DFIs), the AfDB and Afreximbank have sought to bridge this knowledge gap. The first trade finance report highlighted the size of the financing gap and other challenges facing African financial institutions, especially in low income countries. The second examined the trade finance challenges faced by small and medium-size enterprises (SMEs) and commercial banks' first-time trade finance clients.

This third report provides a decade-long review of the trade finance landscape in Africa and offers insights into the role that DFIs play in trade finance intermediation. The survey revealed that unmet demand in trade finance declined significantly from its peak of USD120 billion in 2011 to USD81 billion in 2019. The global response from key players in the trade finance industry, including DFIs, undoubtedly contributed to this decline. DFIs are increasingly playing a more active role in Africa's trade, with facilities for short-term lending of working capital and credit guarantees aimed at SMEs. The survey highlighted that an average of 60% of banks that engaged in trade finance activities received some form of DFI support between 2015 and 2019.

Nevertheless, significant challenges remain. The trade finance gap, while contracting, remains unacceptably high. SMEs, among the most significant contributors to African economies, have witnessed a higher share of their trade finance applications rejected by banks even as the risk profile of their trade finance assets has improved. In addition, compliance with stringent anti-money laundering and know-your-customer measures, along with new Basel regulations, have imposed higher costs on financial institutions in the trade finance sector, leading to fewer banks engaging in trade finance activities.



The report outlines some policy recommendations to help address these challenges, including raising awareness about the impact that stringent regulatory requirements have on African financial intermediaries, with various actors collaborating on approaches that would make compliance more cost effective. It advocates more robust and sustained engagement with SMEs, inviting DFIs to expand their trade finance network of banks that support these enterprises. Finally, it stresses the need to address geographical disparities, particularly with regards to the scope and nature of instruments offered by DFIs to boost African trade, especially intra-African trade, and enhance implementation of the African Continental Free Trade Agreement (AfCFTA).

The AfDB and Afreximbank remain confident that various partners will find this report helpful in their efforts to adapt their trade finance operations to the new challenges facing the thriving African business community and trade finance industry. It is also hoped that the report will further inform their growing collaboration and engagement with relevant stakeholders in the African trade finance landscape, to make trade finance more accessible to African businesses whose success is critical in ongoing efforts to expand Africa's share of global trade and further enhance its integration into the global economy.

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Executive Summary

This report is the third in the "Trade Finance in Africa" research series. It uses a standardized survey of commercial banks to provide a comprehensive study of the trade finance landscape in Africa for the nine years leading up to 2019. The aim is to provide data that set a benchmark for the trade finance landscape in Africa prior to the Covid-19 crisis, and aid policy makers' support of the trade finance industry during and after the pandemic. Besides uncovering new challenges based on trend analyses of the data, particularly those related to new regulations, it also corroborates some previous findings. The report also provides insights into the important role played by development finance institutions (DFIs) in supporting trade finance across Africa, and how that impacts banks' ability to intermediate African trade. The key findings are summarized below:

• **Over the nine years leading up to 2019, the average size of the trade finance gap in Africa was estimated to be USD 91 billion.** It decreased slowly but steadily from USD120 billion in 2011 to USD70 billion as at end-2016. But the downward trend has since reversed. The gap in 2019 was estimated to be USD81.80 billion. Given that the global trade finance gap was estimated to be USD1.5 trillion in 2018, average unmet demand in Africa represents 5.5% of the global trade finance gap. To put this in perspective, total African trade accounts for only 3% of world trade.

• **For the period 2011–19, the average size of bank-intermediated trade finance in Africa was estimated at USD417 billion.** Since total African trade for the same period averaged USD1,077 billion, banks intermediated an average of 40% of Africa's trade. In comparison, 80% of world trade is bank intermediated, suggesting that African trade is significantly underserved by banks.

• **There has been a slow decline in trade finance contribution to total bank earnings – from a peak of 17% in 2011–12 to 10% in 2018–19.** Over 2014–19, earnings from trade finance decreased for all banks except for domestic public banks (state-owned banks). We speculate that this could be the result of high fees from captive clients of state-owned banks. Indeed, for the same period, the average letter of credit opening fee charged by public banks was triple that charged by private banks.

• **During 2011–19, intra-African trade averaged about 17% of total African trade, while an average of 18% of bank-intermediated trade finance was dedicated to financing intra-African trade.** Intra-African trade therefore received its fair share of bank-intermediated trade finance during those years.

• **Participation in trade finance activities by banks has slowly but steadily decreased.** In 2019, 71% of banks in the survey engaged in trade finance activities, compared with 92% in 2011. Competition, new banking regulations on know-your-customer/anti–money laundering (KYC/AML), and strict capital requirements introduced after the global financial crises have increased due diligence costs and decreased margins, making small transactions, particularly for SMEs, unprofitable for banks.

• **While default rates on trade finance assets dedicated to SMEs have decreased sharply, approval rates on applications from SMEs deteriorated consistently in all years but 2017.** The share of SME trade finance applications rejected by banks increased from 20% in 2013 to 40% in 2019. The fear is that the Covid-19 pandemic could further worsen the rejection rate for SME trade finance applications and derail the progress made.

• **Default rates on trade-related transactions in Africa have consistently been lower than those on overall bank lending.** In 2017–19, the average default rate was 7.5% on trade finance facilities, compared with 11% for overall average NPLs for the same period. However, these default rates are far higher than the global default rates on trade finance transaction, which range between 0.03% and 0.24%.

• **DFIs are playing a more active role in support of trade finance intermediation in Africa.** During 2015–19, an average of 60% of banks that engaged in trade finance activities received some form of DFI support. But the distribution is far from even. Support from DFIs is concentrated among banks based in West and Southern Africa and foreign-owned private banks throughout the continent.

• **Citibank, Commerzbank, Deutsche Bank, Standard Chartered Bank, and UBAF continue to top the list of correspondent banks servicing issuing banks in Africa.** However, all but Citibank had lower shares of correspondent relationships with African issuing banks during 2015–19 than in previous waves of the survey. This shows a general retreat from correspondent relationships with African issuing banks.

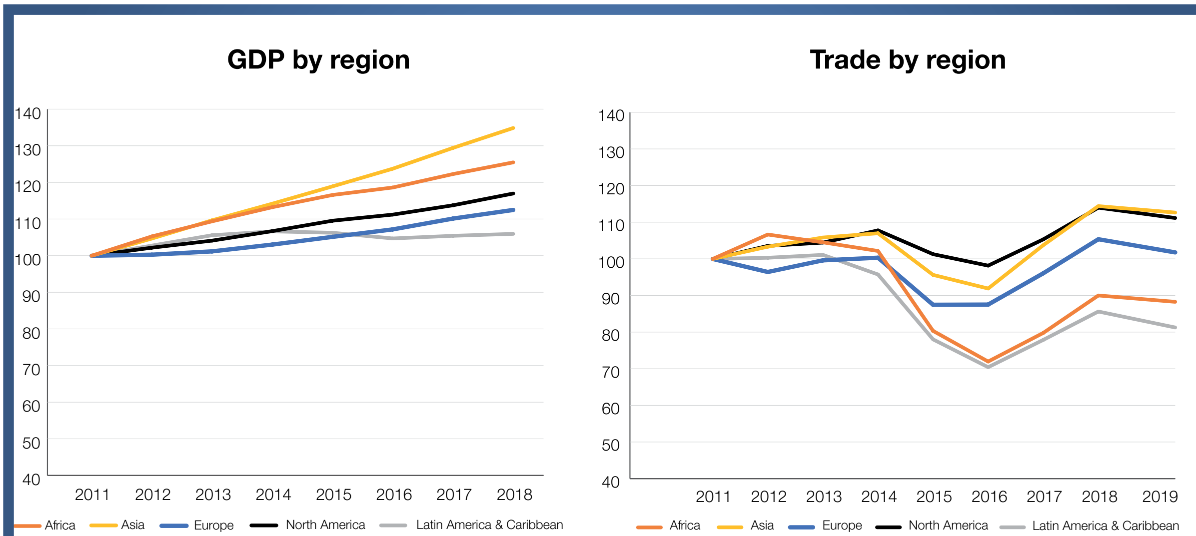
• **While banks continue to list weak client creditworthiness (30%) and insufficient collateral (25%) as the key reasons for rejecting trade finance applications, new challenges have emerged.** About 16% of the banks engaged in trade finance now list KYC/AML compliance as the major reason for rejecting trade finance applications in the period from 2015-19, compared with less than 1% in 2013–14. This shows that stringent KYC/AML regulations are having unintended consequences on African banks engaged in trade finance.

TRADE FINANCE IN AFRICA:
EMERGING TRENDS AND OPPORTUNITIES

1. Introduction

Trade is an important driver of Africa's growth and development. By most measures, the region was one of the most integrated with the rest of the world in 2011. Its aggregate trade to GDP ratio – a standard measure of the degree of openness – stood at 57%, above the global average of 54%. This level of integration into the global economy has many potential benefits. By opening to foreign markets, firms are forced to compete and adopt innovative production techniques around the world, becoming more productive and efficient in the process. But much has changed since 2011. While the region's GDP has seen a slow but steady growth above 2011 levels, its aggregate trade growth has been one of the worst among the major regions of the world (see Figure 1).

Figure 1 - Changes in world regional GDP and trade (2011 = 100)

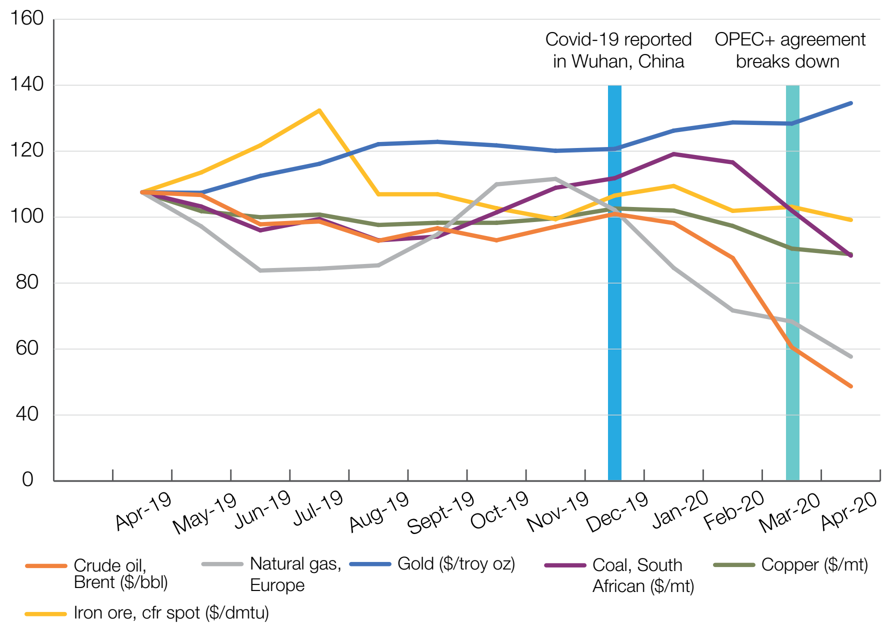


Source: AfDB-Afreximbank staff calculations from WTO and World Development Indicators databases.

The divergence partly reflects the effects of falling commodity prices, but it also underscores challenges related to access to trade finance in Africa. About 80% of world trade relies on some form of trade finance (Auboin, 2009), but the distribution is far from even. Firms in low-income economies consistently list the lack of access to finance among the top three export challenges (World Economic Forum, 2016). In addition, banks that provide the liquidity and risk mitigation facilities that underpin global trade are gradually scaling back activities from riskier markets – particularly in Africa – as they go through a "de-risking" process due to increasingly stringent KYC/AML regulations and capital requirements (World Bank, 2018). Barclays PLC's exit from the region was much publicized in 2016. In the absence of bank-intermediated trade finance, firms rely on more expensive forms of financing such as cash-in-advance contracts with trading counterparts. SMEs and new firms that lack the track record to gain trust and access to inter-firm credit from trading counterparts are often forced to exit foreign markets.

Increasingly, it is becoming clear that the on-going Covid-19 pandemic could add to the burden of risks facing African trade and trade finance. The pandemic has already resulted in sharp falls in the prices of most of Africa's top export commodities (see Figure 2). As export revenues fall and the balance sheet of firms and banks deteriorate, it could reduce access to foreign exchange liquidity and banks' willingness to engage in trade finance transactions. While policy makers have been keen to tackle the challenges facing the trade finance market, especially in a time of crisis, a lack of standardized data often undermines efforts to gauge the scale of the problem and develop appropriate policy interventions. This series of "Trade Finance in Africa" reports aim to fill this gap.

Figure 2 - Monthly changes in the price of Africa's top export commodities



Source: AfDB-Afreximbank staff calculation from World Bank Commodity Price Database

1.1 About the report

In 2013, the African Development Bank (AfDB) launched its first "Trade Finance in Africa" survey. The aim was to support the Bank's policy response to post-2008 challenges facing the trade finance industry. Although experts believed at the time that the market was severely underserved, the scale of the challenge and the size of unmet demand were largely unknown due to a lack of data. The first report was published in 2014 (African Development Bank, 2014). Among the key findings, it uncovered significant unmet trade finance demand valued at USD110–120 billion – far greater than the USD25 billion that experts had suggested.

To focus on the broader challenges facing the industry at the regional level, the first report devoted little attention to understanding market segments where the needs were the highest, particularly for SMEs. To fill this gap, a new survey was conducted in 2015, covering 2013–14 (African Development Bank, 2017). In addition to expanding on the earlier data, it also devoted attention to trade finance supply for SMEs and new entrants to export markets. It found, for instance, that only 28% of trade finance was devoted to SMEs, although they made up 80 percent of enterprises in Africa during the time measured.

This report is the third in the "Trade Finance in Africa" series and was conducted jointly by the African Development Bank and the African Export-Import Bank (Afreximbank). It expands on the previous two studies to include the period 2015 to 2019. Together, the data provides the most comprehensive analysis on the trade finance landscape in Africa for the nine years leading up to 2019. The use of a standardized survey means the findings are comparable across time and sub-regions. For the first time, the report leverages insights into the important role development finance institutions (DFIs) play across Africa and how that impacts the ability of banks to support African trade. The report also takes a deeper dive into the distribution of trade finance assets across major industries and financing instruments. Besides corroborating some of the previous findings, it also uncovers new challenges based on trend analyses of the data – particularly those related to new regulations.

1.2 About the survey

The report is based on a survey of commercial banks in Africa conducted in three waves covering the period 2011 to 2019. Data for 2019 are projections based on data from 2011 to 2018. The questionnaire was distributed to more than 1,000 individual banks over the study period. An average of 259 banks responded to the survey across the three waves of the study – a response rate of nearly 26%. Together, the surveys provide an unbalanced panel data of 2,333 observations from 49 different countries and 670 individual banks for the nine-year period. The survey solicited information on trade finance assets of responding banks including asset size, approval and rejection rates, distribution by industry, funding type (funded and unfunded), default rates and the reasons for rejections. In addition, it captured information on bank-level characteristics including ownership type, size (total assets, customer deposits and equity) and financial characteristics (after tax profits and non-performing loans ratio).

The sample includes information from a diverse group of banks, including domestic private banks, public banks, foreign-owned banks, and others. On average, private foreign banks constituted 51% of all respondents, followed by privately-owned local (25%) and majority government-owned banks (12%) (see Figure 3). At the sub-regional level, banks based in West Africa accounted for over a third of all respondents. Those based in East and Southern Africa each accounted for about a quarter of respondent banks. North and Central Africa had the lowest response rate at 6% and 11%, respectively (see Figure 4).

Figure 3 - Number of banks that responded to the survey and distribution by ownership type

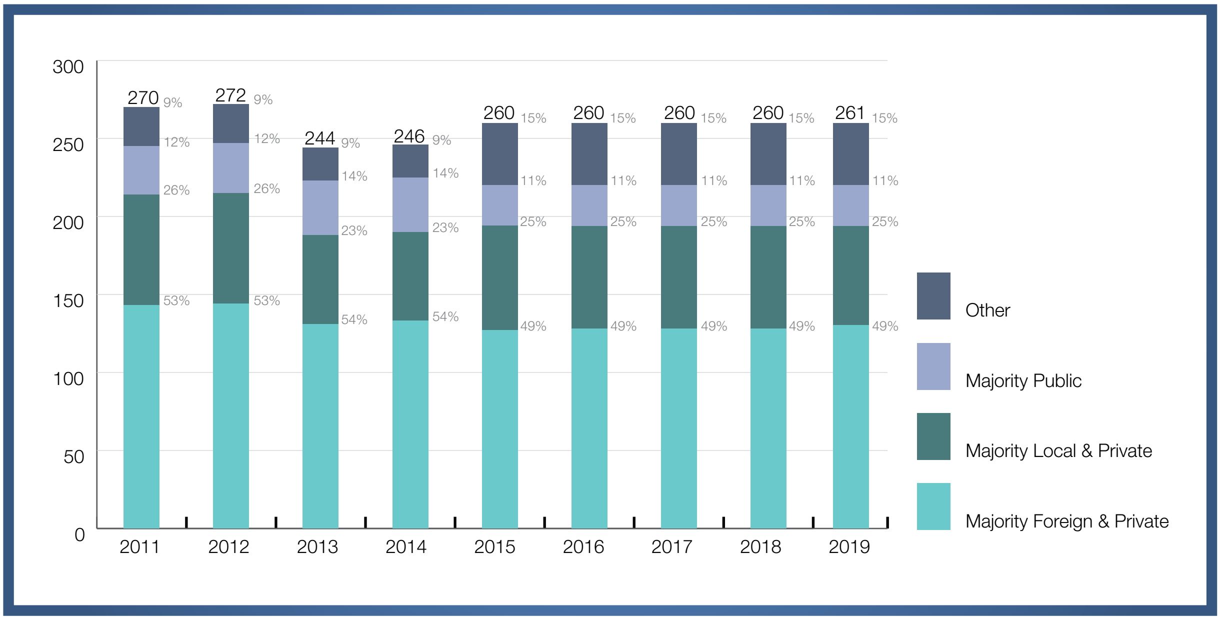
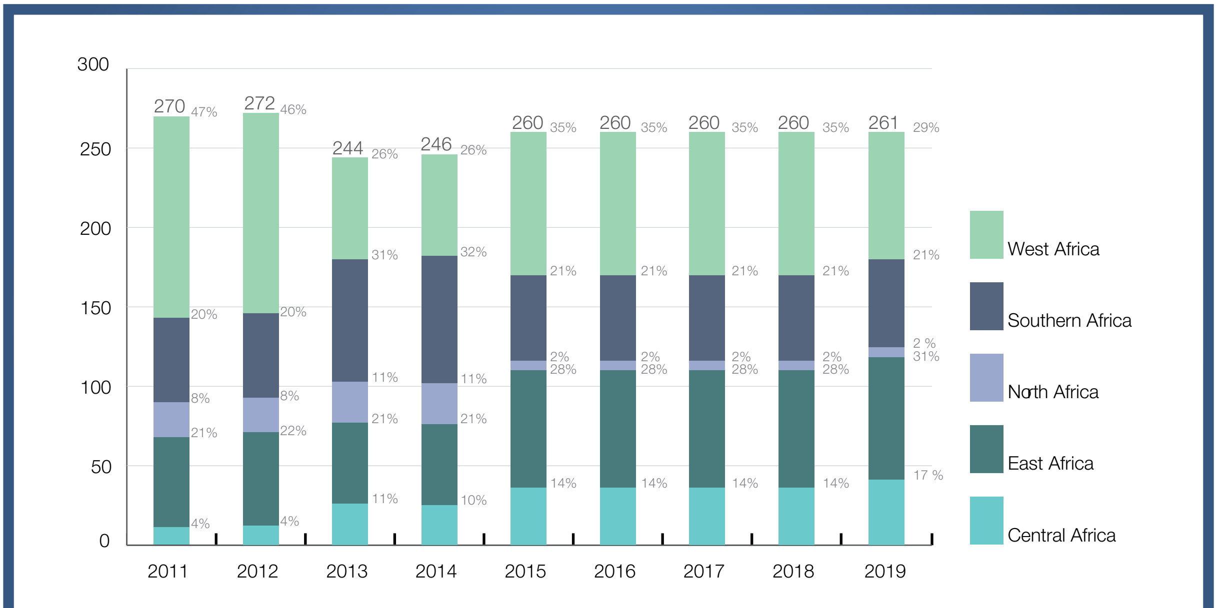


Figure 4 - Number of banks that responded to the survey and distribution by sub-region



2. Banks in Trade Finance

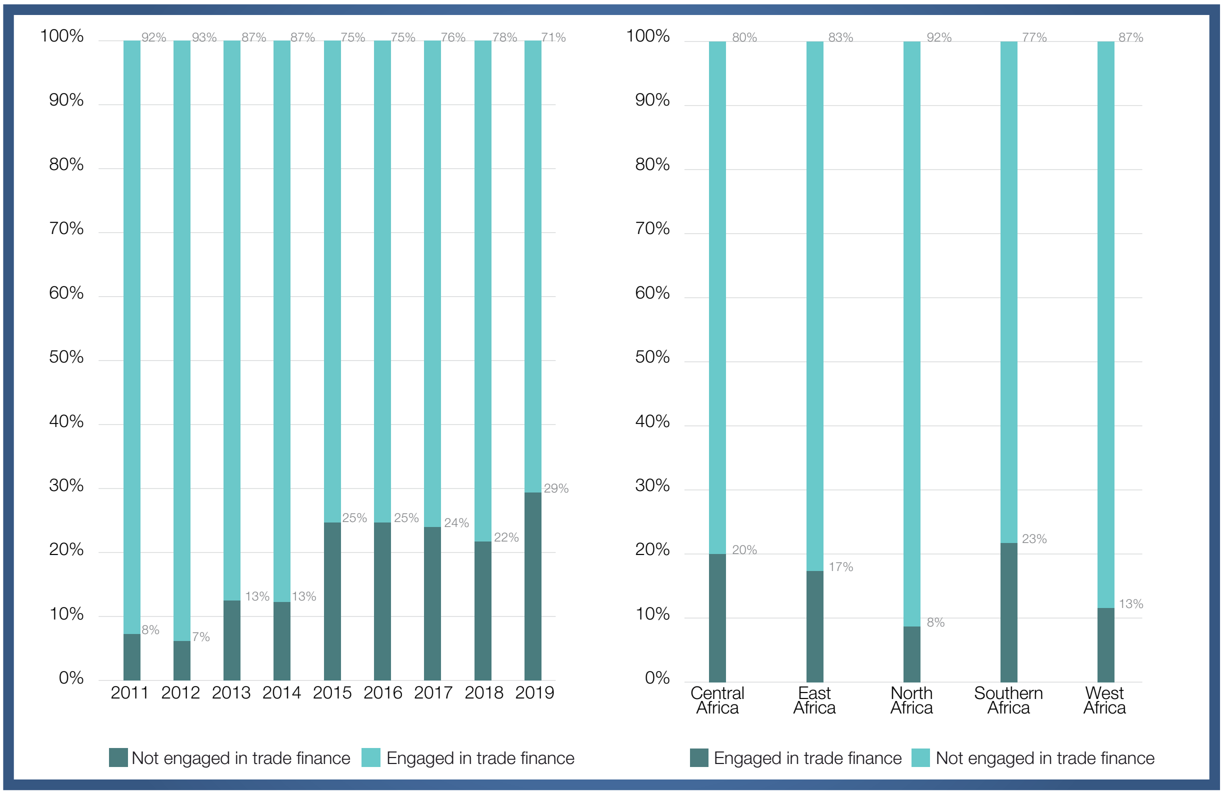
2.1 Participation in trade finance

> Trade finance remains a popular activity among banks in Africa, but participation rate continues to decrease – falling by 16% between 2013 and 2019

The study shows that trade finance remains a popular activity among banks in Africa, but the participation rate continues to decrease. From the 2013-14 survey, 87% of the Banks that responded engaged in trade finance activities compared with 71% in 2019 - a decrease of 16 percentage points. This could be due to a combination of increased competition, adoption of stricter Basel III regulatory requirements and new anti-money laundering standards that have reduced profit margins and increased operational costs, thereby making trade finance unprofitable for small banks.

At the sub-regional level, average bank participation rates in trade finance are highest in North Africa (92%) and West Africa (87%) and lowest in Central Africa (80%) and Southern Africa (77%) respectively (see Figure 5).

Figure 5 - Share of banks in Africa engaged in trade finance by year and sub-region



Box 1: Bank-level drivers of trade finance participation

Several factors may influence banks' participation in trade finance transactions. At the country level, access to foreign exchange liquidity, the level of GDP growth, competition, capital requirements and interest rates may impact banks' ability and decision to participate in trade finance markets.

However, bank-level characteristics may also play a role. We compare the characteristics of banks that engage in trade finance activities to those that do not to obtain an understanding of some of the bank-level characteristics that influence engagement in trade finance activities. We consider three main bank level characteristics: whether a bank receives DFI support to promote trade, if it has majority foreign-ownership or not, and whether the bank has above-average profit levels (which in our sample is USD430 million) or not.

The results are presented in Table 1, using a mean comparison test with equal variance. More profitable banks that are foreign-owned and receive DFI support are more engaged in trade finance activities than those that do not. Participation rates are 10 percentage points higher for banks with DFI support and above-average profit, and 7 percentage points higher for banks that are foreign owned. It is worth stating that some of these factors may be confounding. For instance, it is possible that banks that engage in trade finance receive support from DFI, rather than DFI support determining bank participation. A more detailed analysis that accounts for such reverse causality is needed to isolate these effects.

Table 1- Characteristics of banks engaged in trade finance vs. those that do not

Mean comparison test of the difference in trade finance participation by group

VARIABLES	Participate in trade finance	Do not participate in trade finance	Difference
DFI Support (Yes or No)	0.999	0.893	0.106***
	(0.000)	(0.015)	(0.0333)
Foreign Participation (Yes or No)	0.864	0.795	0.069***
	(0.011)	(0.013)	(0.016)
Profitability (> average USD430 million)	0.873	0.768	0.105***
	(0.009)	(0.0148)	(0.0167)

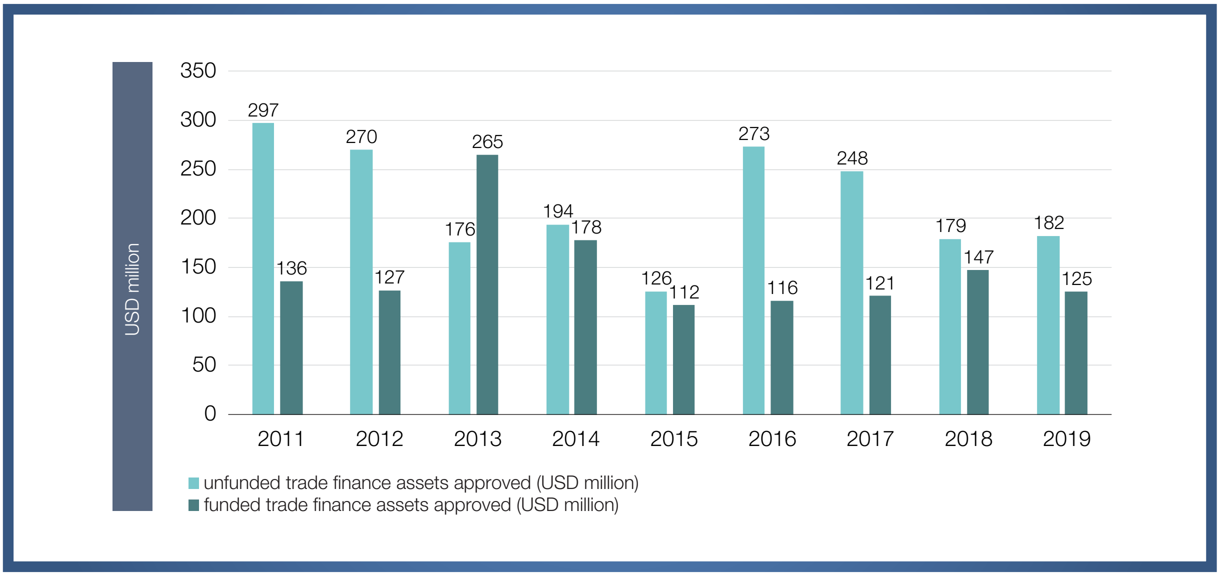
Note: *Standard errors in parentheses, *** p<0.01, ** p<0.05, * p<0.1*

3. Characterization of Trade Finance in Africa

3.1 Funded and unfunded trade finance assets

The survey shows that 60% of trade finance assets of banks are unfunded transactions, such as letters of credit and documentary collections. Unfunded trade finance assets have been higher than funded assets such as import loans for all the years under survey except in 2013. The average size of unfunded assets for banks during 2011–19 was about USD216 million relative to USD150 million for funded assets. Put together, average trade finance asset size has shown significant variability across the sample period. It was highest in 2011 at USD433 million but decreased by more than 45% to USD237 million in 2015 (see Figure 6). This was largely attributed to commodity price shocks in 2015 that reduced total trade value and the associated trade finance.

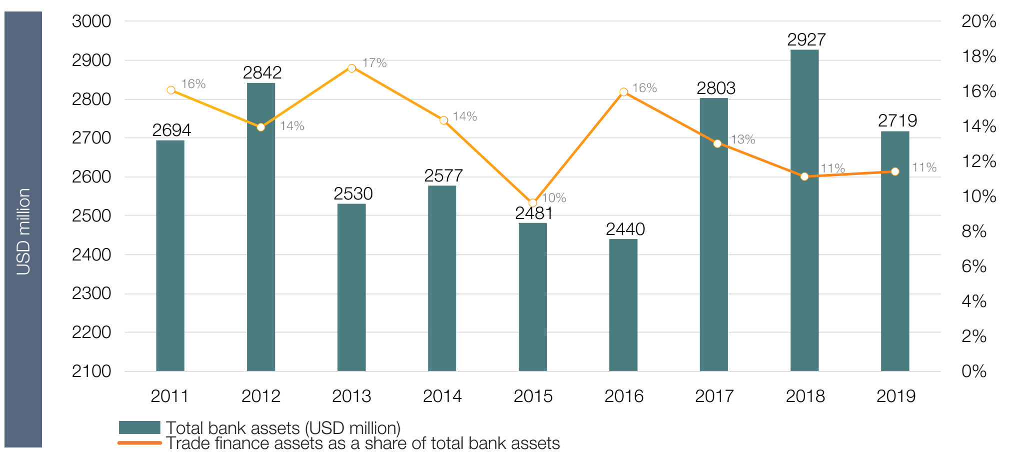
Figure 6 - Average value of funded and unfunded trade finance assets by year



On average, trade finance assets accounted for 14% of total bank assets in Africa between 2011 and 2019.

The share of total bank assets dedicated to trade finance shows significant variability over the study period. In 2019, the average bank in our sample had total assets of USD2.7 billion. Given that the average value of total trade finance portfolio was USD307 million, trade finance assets therefore accounted for 11% of total bank assets in 2019, a decline of five percentage points from 16% in 2016 (see Figure 7).

Figure 7 - Average value of bank assets in Africa and trade finance (funded and unfunded) assets as share of total bank assets by year



At the sub-regional level, North Africa had not only the highest proportion of banks engaged in trade finance but also the highest average value of unfunded and funded assets in absolute terms and as a proportion of total bank assets (see Figure 8). Between 2011 and 2019, it accounted for close to half the total average value of unfunded trade finance assets in Africa and 45% of total trade finance assets. For the same period, trade finance assets accounted for 40% of total bank assets in North Africa, a far higher proportion than in the other four sub-regions. In Southern Africa, the share is 18%, and for both East and West Africa it is 11% (see Figure 9).

Figure 8 - Average values of funded and unfunded trade finance assets by sub-region (USD million)

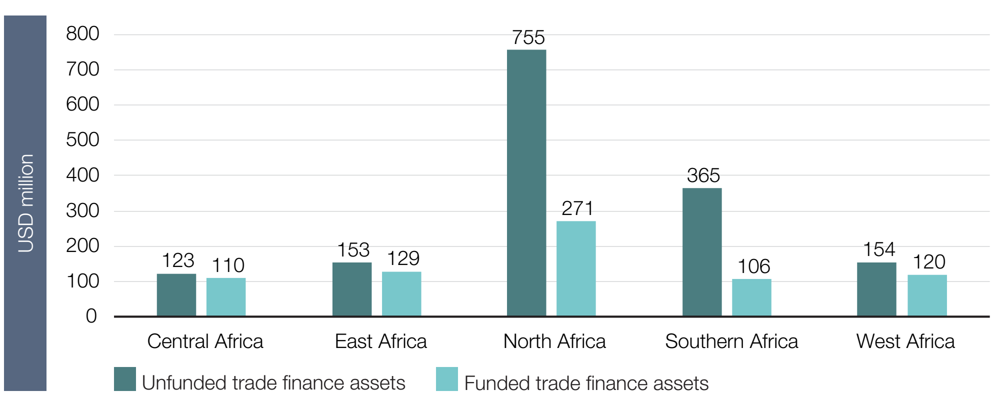
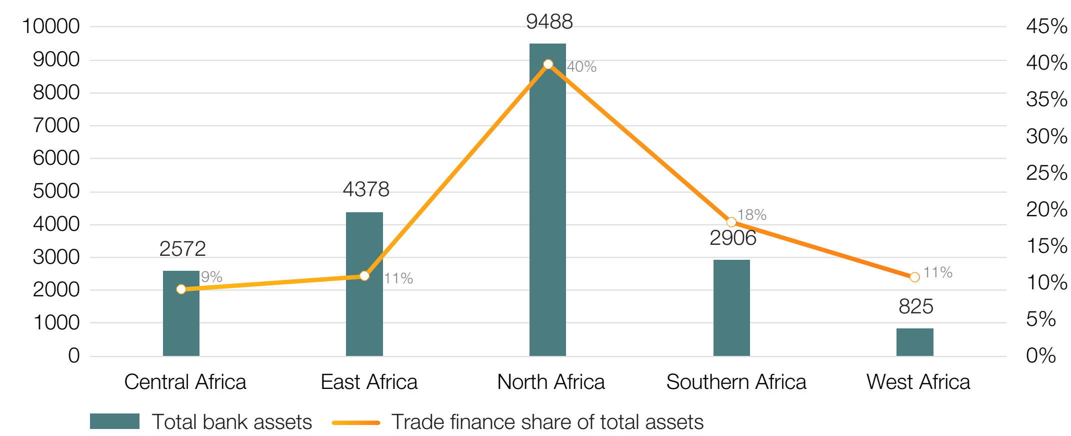


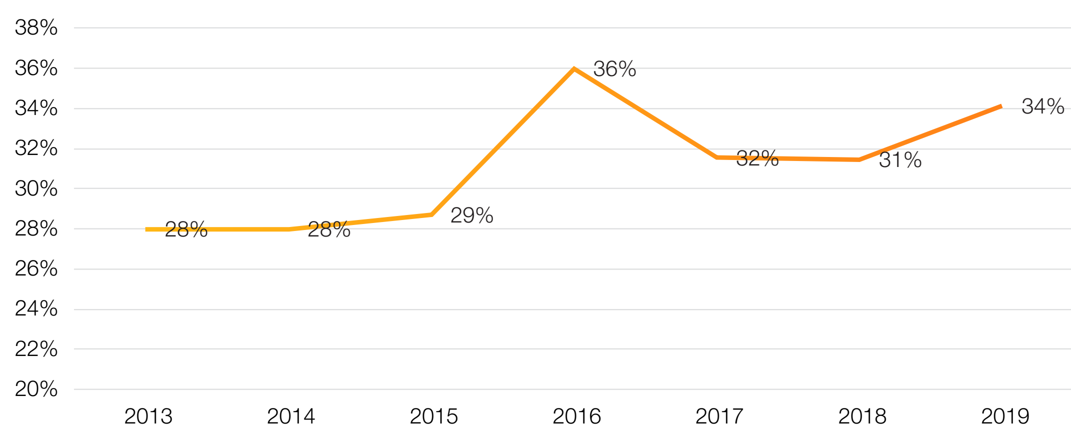
Figure 9 - Average values of total bank assets (USD million) and trade finance assets as a share of total bank assets by sub-region



3.2 Trade finance assets for SMEs

SMEs are an important driver of growth in Africa. They make up 80% of all businesses in sub-Saharan Africa and account for up to 80% of all jobs in the region (World Economic Forum, 2015). Yet, they also face the greatest challenges in accessing trade finance on competitive terms (World Trade Organization, 2016). To help understand the extent to which SMEs are underserved with respect to trade finance in Africa, the survey solicited data on the share of trade finance assets dedicated to SME.

Figure 10 - Average share of trade finance portfolio for SMEs by year



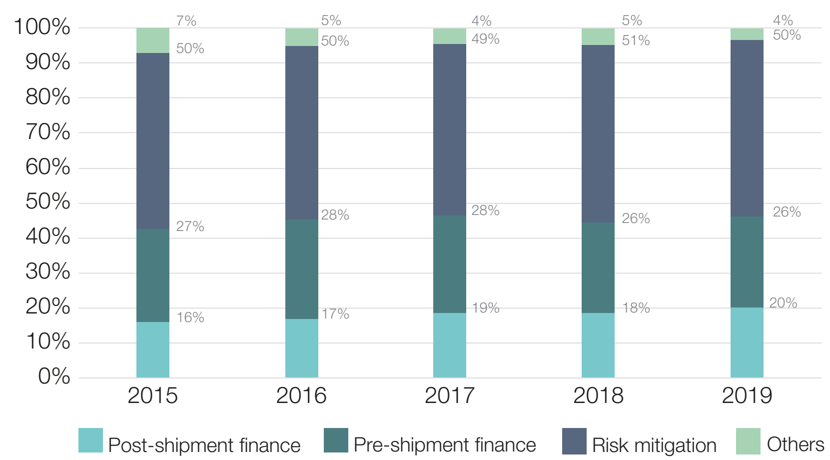
Note: Data on SME share of trade finance are available starting in 2013.

The results show that SMEs' share of trade finance assets has trended upward. In 2011–12 only 28% of trade finance assets were dedicated to SME trade finance. In 2019, that figure had increased by six percentage points, to 34% (see Figure 10). As African-based SMEs increasingly view international trade as part of their strategies to become part of the global supply chain, it is important to ensure the sustainability of access to trade finance for SMEs across the region. The fear is that if the Covid-19 pandemic persists, it could derail the progress made towards access to finance for SMEs.

3.3 Trade finance assets by instrument type and sector

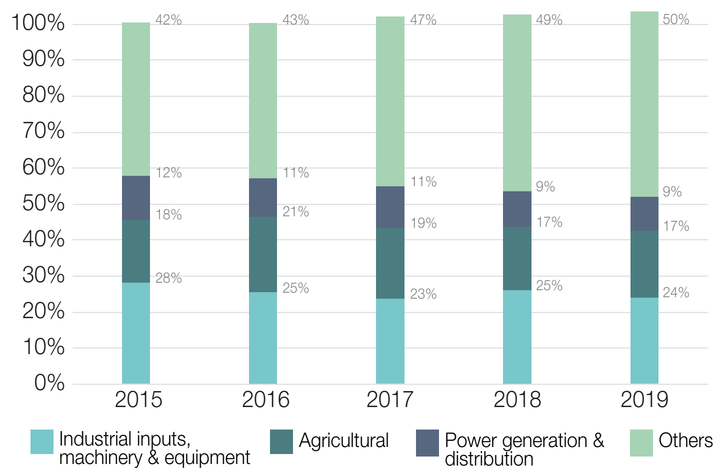
The survey also shows the importance of risk-mitigating trade finance instruments for African trade with the rest of the world. On average, half of banks' trade finance portfolios were associated with less risky (from an exporter's perspective) instruments such as letters of credit and documentary collections. On-Balance sheet transactions such as import loans and pre- and post-export finance instruments accounted for 45% of banks' portfolios related to trade finance. The remaining 5% were associated with other instruments (see Figure 11).

Figure 11 - Trade finance portfolio distribution by funding type and year



In terms of the sectoral distribution, the survey shows that a quarter of trade finance assets relate to capital goods such as machinery and equipment, which is in line with the proportion of capital goods imports in Africa's total imports (26%). A fifth of all transactions were associated with trade in agricultural goods while about 11% financed trade in energy related products (see Figure 12). This confirms the importance of trade finance in supporting sectors such as industrialization, agriculture and power generation that are priorities for regional DFIs including the AfDB.

Figure 12 - Trade finance portfolio distribution by sector and year

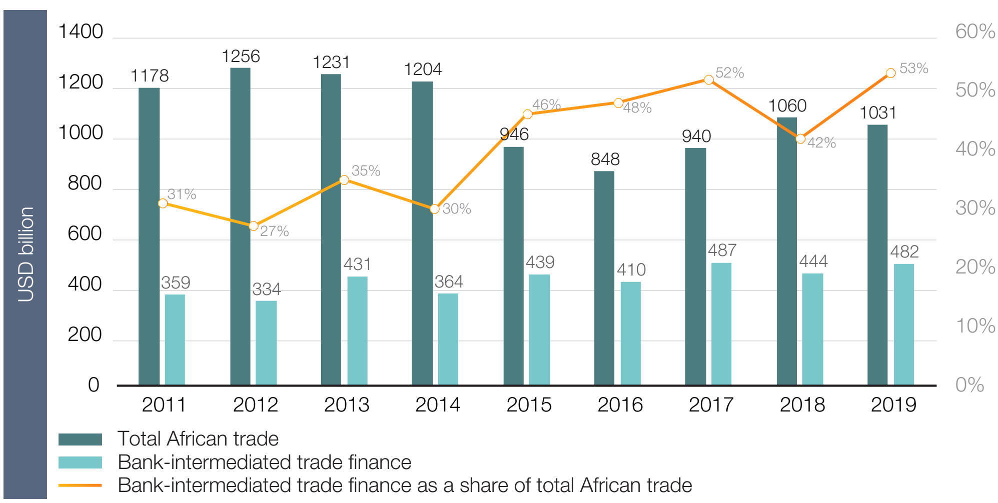


4. Size of Bank-Intermediated Trade Finance

While up to 80% of trade is supported by some form of bank intermediation globally, there are significant gaps in trade finance provision (World Trade Organization, 2016), with certain sectors and regions often underserved. We use the average values of funded and unfunded trade finance transactions and the share of banks that engage in trade finance activities to estimate the size of bank-intermediated trade finance in the region (see Figure 13).

> African trade is significantly underserved by banks. For the period 2011-19, Banks intermediated about 40% of total African trade, compared to the global average of 80%

Figure 13 - Size of bank-intermediated trade finance and share of total African trade



Note: *The size of bank-intermediated trade finance is estimated based on the total number of banks in Africa, average value of unfunded and funded trade finance assets, and the share of banks that reported that they engage in trade finance transactions. The data is from the AfDB-Afreximbank trade finance database. Data for total African trade is obtained from the World Trade Organization's International Trade and Tariff database.*

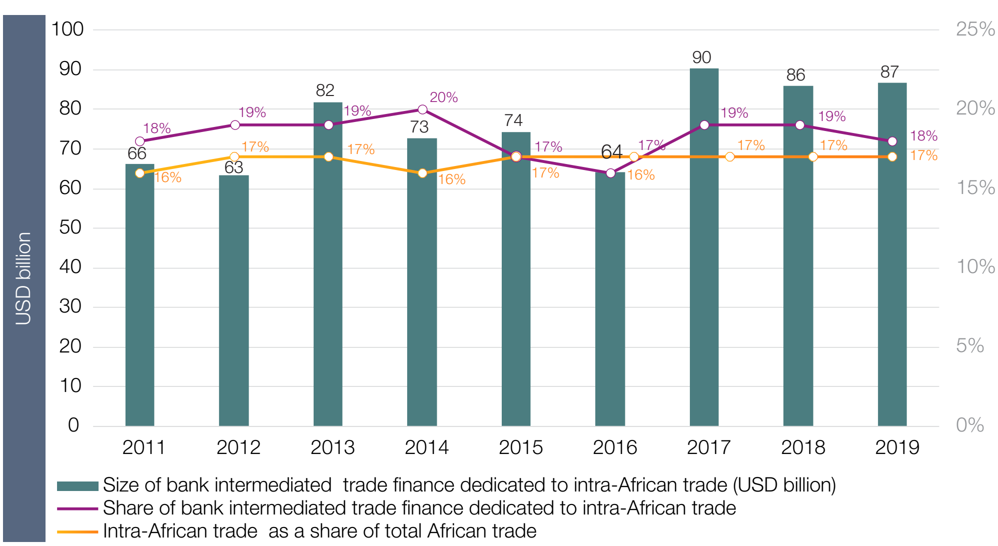
Between 2011 and 2019, the average value of bank-intermediated trade finance stood at USD417 billion, reaching its highest level in 2017 at USD487 billion. Since then, it has fallen by nine percent to USD482 billion in 2019. To put this in perspective, total African trade averaged USD1,077 billion over the same period. This shows that on average banks intermediated about 40% of total African trade. Compared to the share of global trade that is supported by bank trade finance (80%), African trade is significantly underserved by banks.

While 17% of total African trade is intra-African, the share of trade finance dedicated to intra-African trade is 18% - intra-African trade therefore receives its fair share of bank intermediated trade finance.

As banks reported information on the share of trade finance (off- and on-balance sheet) transactions that are dedicated to intra-African trade, we can estimate the size of bank-intermediated trade finance dedicated to intra-African trade by multiplying the total size of bank-intermediated trade finance with the share of trade finance dedicated to intra-African trade. Figure 14 presents these results, illustrating that trade finance dedicated to intra-African trade averaged about USD75 billion and represented an average of 18 percent of total bank- intermediated trade finance between 2011 and 2019.

In 2019, trade finance dedicated to intra-African trade was USD87 billion and represented 18% of the total size of bank-intermediated trade finance for that year. It is worth noting that in the same year intra-African trade accounted for 17% of total African trade. Hence, while the absolute value of bank-intermediated trade finance dedicated to intra-African trade appears low relative to total African trade, in proportionate terms, intra-African trade receives a reasonable share of total bank-intermediated trade finance in Africa.

Figure 14 - Size and share of bank-intermediated trade finance in Africa dedicated to intra-African trade



Source: *AfDB-Afreximbank staff calculations based on Trade Finance in Africa and IMF Direction of Trade databases.*

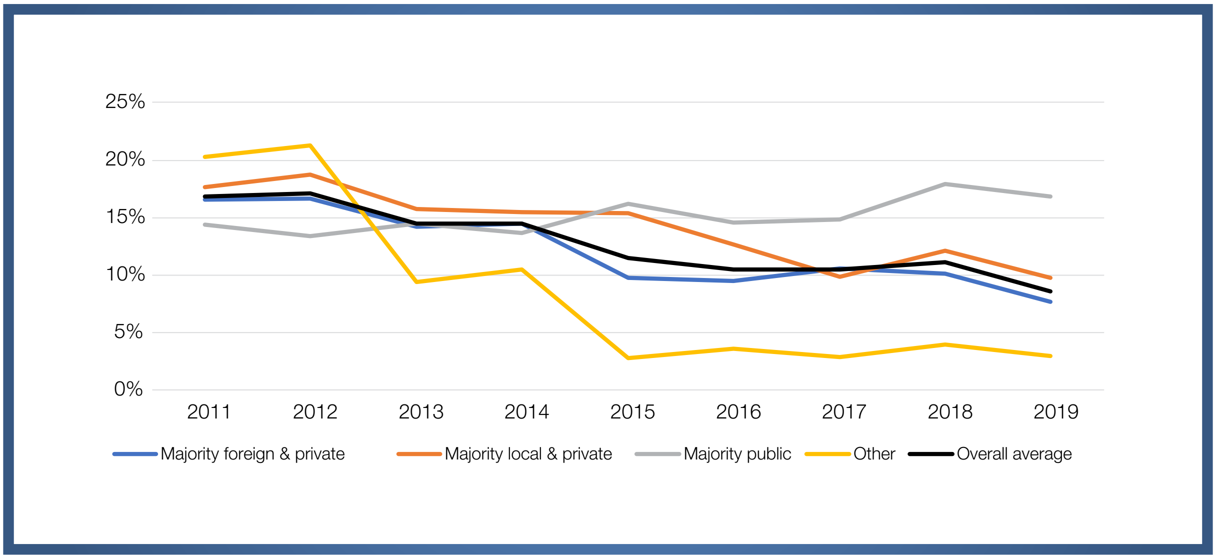
5. Performance and Risk Profile of Trade Finance Assets

5.1 Importance of trade finance to banks' earnings

Trade finance remains a lucrative endeavor for commercial banks but its contribution to banks' earnings has decreased from levels experienced in 2011–12. Between 2015 to 2019, trade finance activities contributed an average of 10% to total bank income, down from 15% in 2014. This could partly be the result of increased competition and higher transaction costs for banks. But trade finance earnings also depend on the volume of transactions and overall trade growth. Hence, as African trade fell below 2013 levels largely due to falling commodity prices, so did bank earnings from associated trade finance activities.

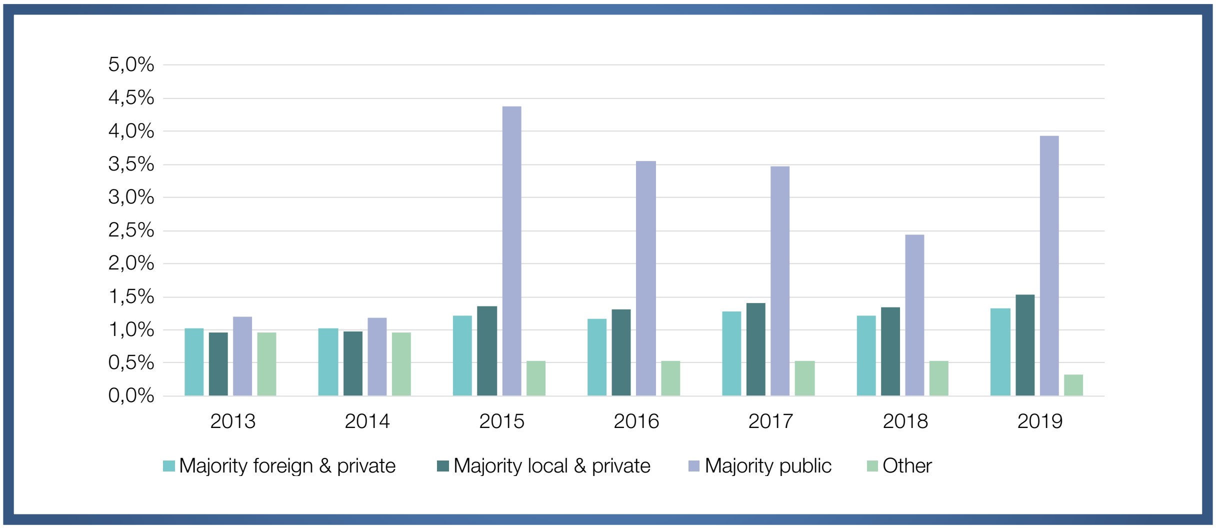
The contribution of trade finance to bank earnings has decreased from 17% in 2011-12 to about 10% in 2018-19 due to higher processing fees and falling trade volume.

Figure 15 - Average income from trade finance activities (% of total bank income) by year and bank ownership type



There is significant variability in terms of trade finance earnings between state-owned banks and private banks (both foreign and domestic). Figure 15 confirms the downward trend in income for all bank types except public banks. On average, trade finance share of total bank income has decreased for all banks since 2014, while it increased for public banks from 14% to 17% in 2019. It is not clear why earnings from trade finance are higher for public banks. Perhaps part of the rationale is high transaction fees charged by state-owned banks.

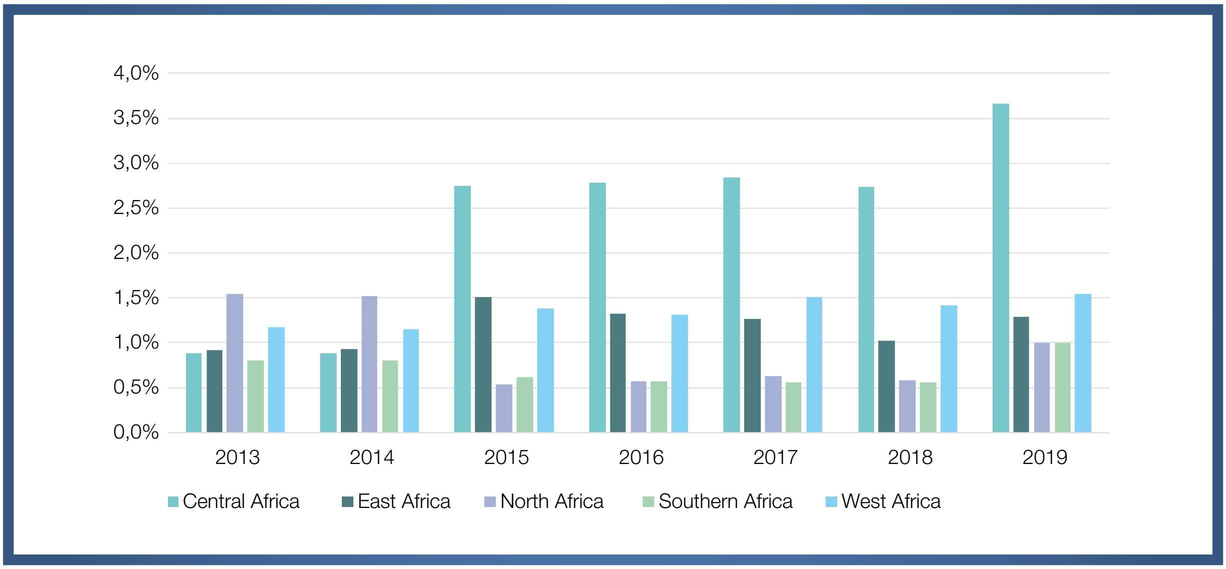
Figure 16 - Average letter of credit opening fee per quarter (as % of LC value) by bank ownership type



For instance, beginning in 2015 when trade finance share of earnings for public banks started diverging from those of private banks, average opening fees charged for letters of credit by public banks were higher than those charged by private banks by at least a factor of two (see Figure 16).

It is also not clear why average letters of credit fees are higher for public banks. In part it may be that most public banks have a captive trade finance client base for trade transactions related to state-owned enterprises or clients for public related trade contracts. Average letter of credit opening fees have become more expensive in Central Africa since 2015 but have decreased in North and Southern Africa (see figure 17).

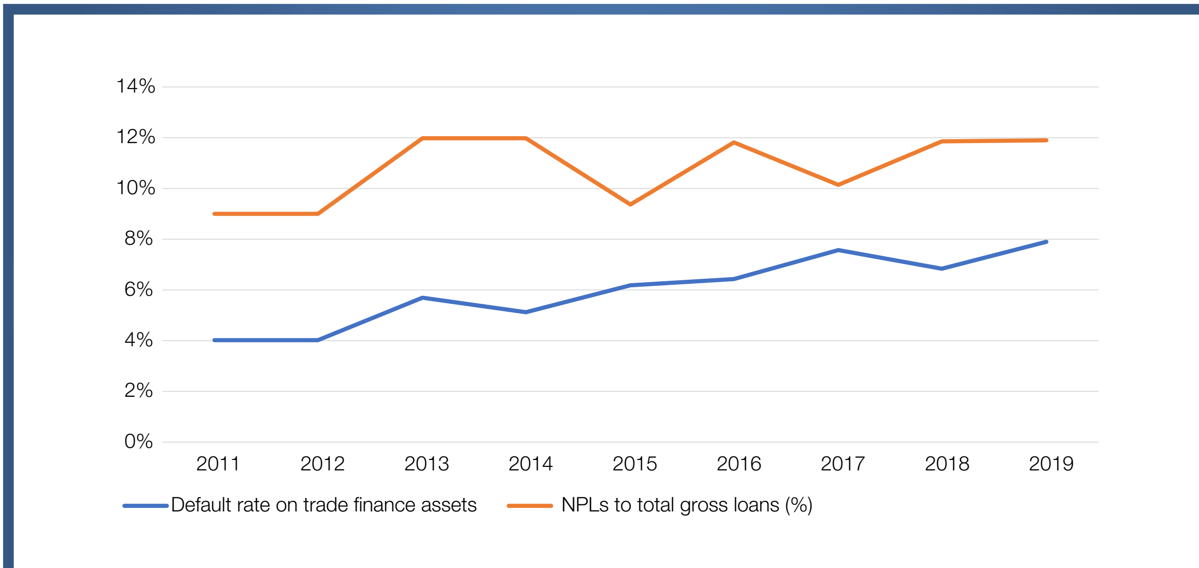
Figure 17 - Average letter of credit opening fee per quarter (as % of LC value) by sub-region



5.2 Risk profile of trade finance

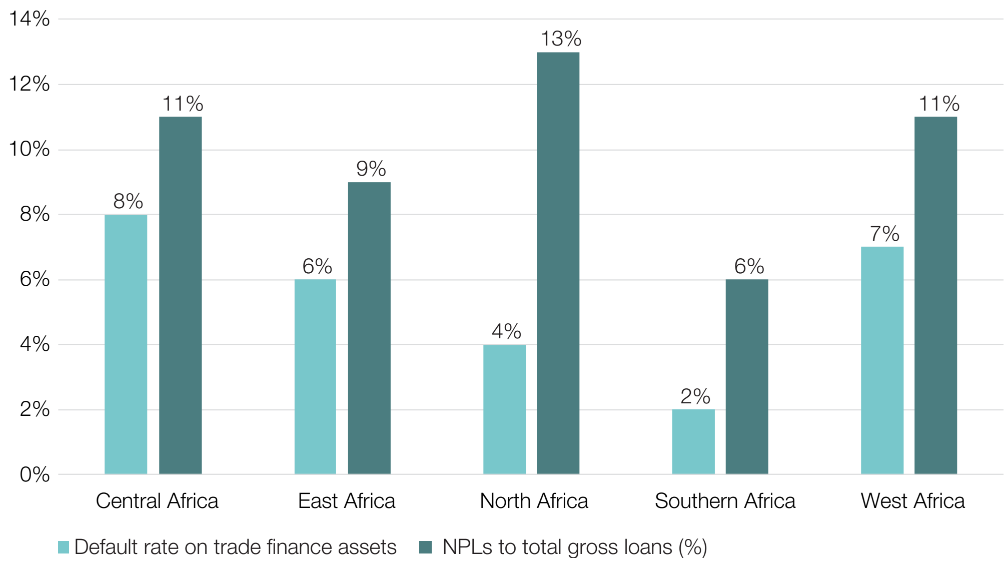
Since trade finance transactions are often asset-backed, self-liquidating, and short-term in nature, they remain relatively low-risk activities. Default rates on trade related transactions have been consistently lower than on overall bank lending in Africa. From 2017 to 2019, the average default rate on trade finance facilities was 7.5%, compared with 11% for overall average NPLs for the same period (Figure 18). By comparison, global default rates for a range of trade-related transactions are between 0.03% and 0.24% (International Chamber of Commerce, 2017). The average default rate on trade finance transactions between 2011 and 2019 was lowest in Southern Africa (2%), which had overall average NPLs of 6%. Default rates were highest in Central and West Africa, at 8% and 7%, respectively, compared with overall NPLs of 11% on bank assets in those sub-regions (see Figure 19).

Figure 18 - Average default rate on trade finance portfolio relative to overall non-performing loans (NPLs)



While average default rates on trade finance activities by African banks are lower than overall bank NPLs in Africa, they are far higher than the default rate on global trade finance activities

Figure 19 - Average default rates on trade finance portfolio relative to overall non-performing loans (NPLs) by sub-region



***Source: AfDB-** Afreximbank staff calculations. NPLs to total gross loans data obtained from World Development Indicators, World Bank.*

5.3 SME default rates on trade finance assets

Default rates for SME trade finance assets went down significantly below levels seen in 2013–14 (14%) but remained relatively stable, at about 10%–11% during 2015–19. As many African governments have promoted export-led growth and internationalization for SMEs – and continue to do so – access to trade finance has become critical for new entrants to foreign markets. Such clients often struggle to obtain access to trade finance due to a limited track record and lack of experience in foreign markets. As borrowers rarely switch providers for trade transactions (Economist , 2019), we use default rates on clients that have established new relations with banks for less than a year to gauge the risk profile of new clients in the trade finance market in Africa. The survey shows that average default rates for such clients are low: 2% in 2016–19, one percentage point lower than in 2013–15 (see Figure 20).

At the sub-regional level, banks in Southern and North Africa reported the lowest default rates on new clients' trade-related transactions (1%). Average default rates for banks in Southern Africa were half that of those in other sub-regions. Central Africa and East Africa reported the highest default rates for trade finance transactions associated with SMEs and new clients, at 19% and 4% respectively (see Figure 21).

Figure 20 - Average default rate on trade finance activities for SMEs, new customers, and overall trade finance assets by year

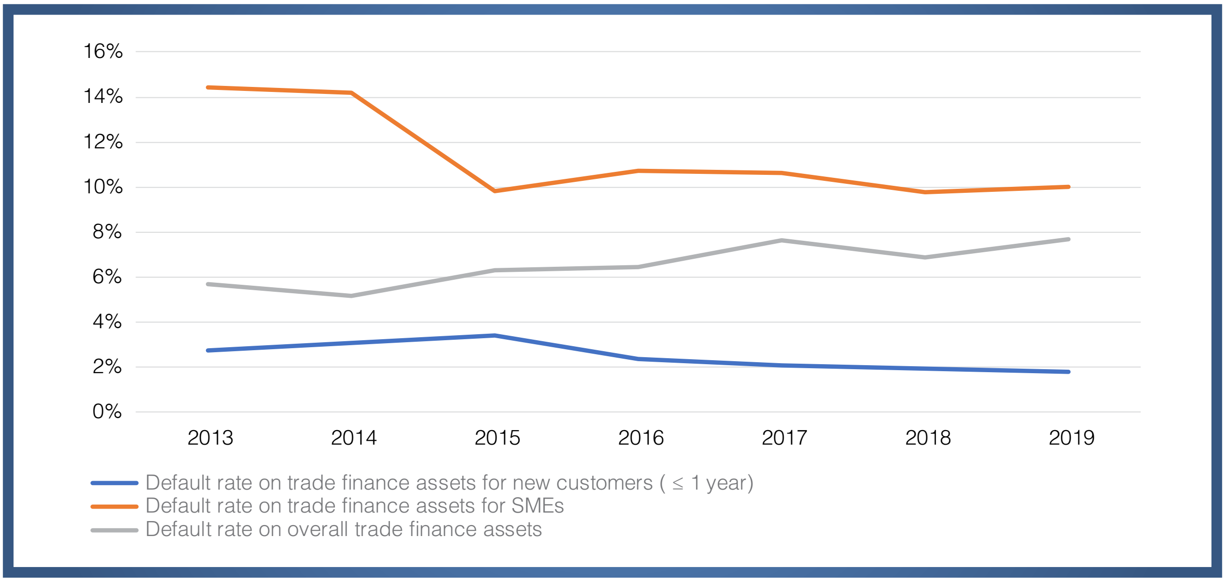
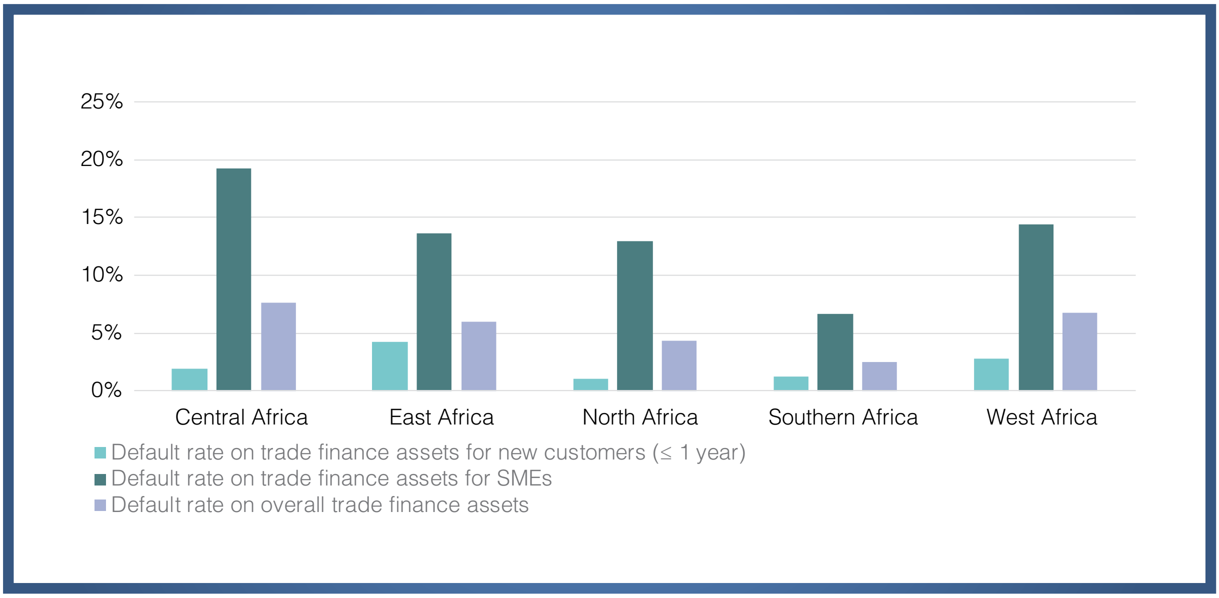


Figure 21 – Average default rate on trade finance activities for SMEs, new customers, and overall trade finance assets by sub-region

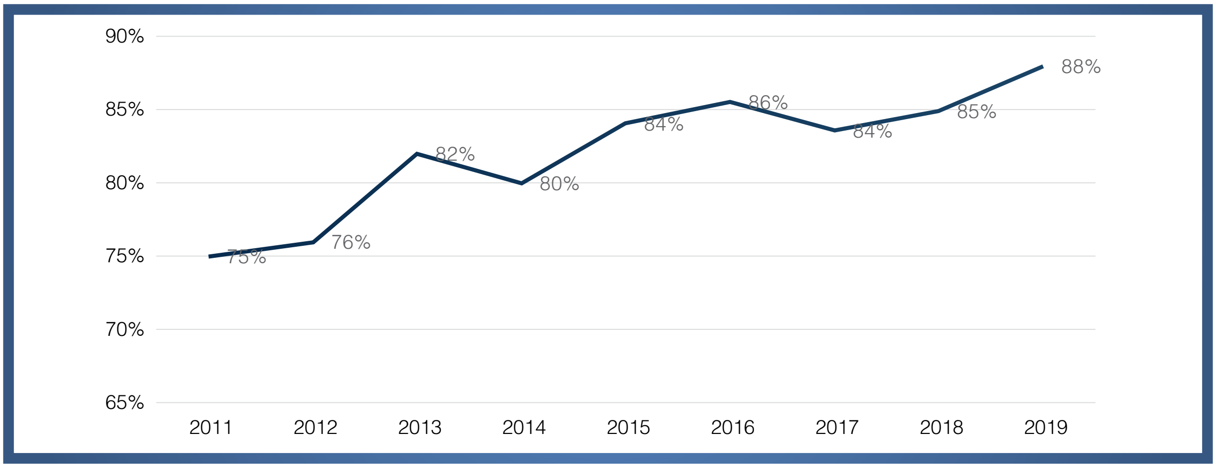


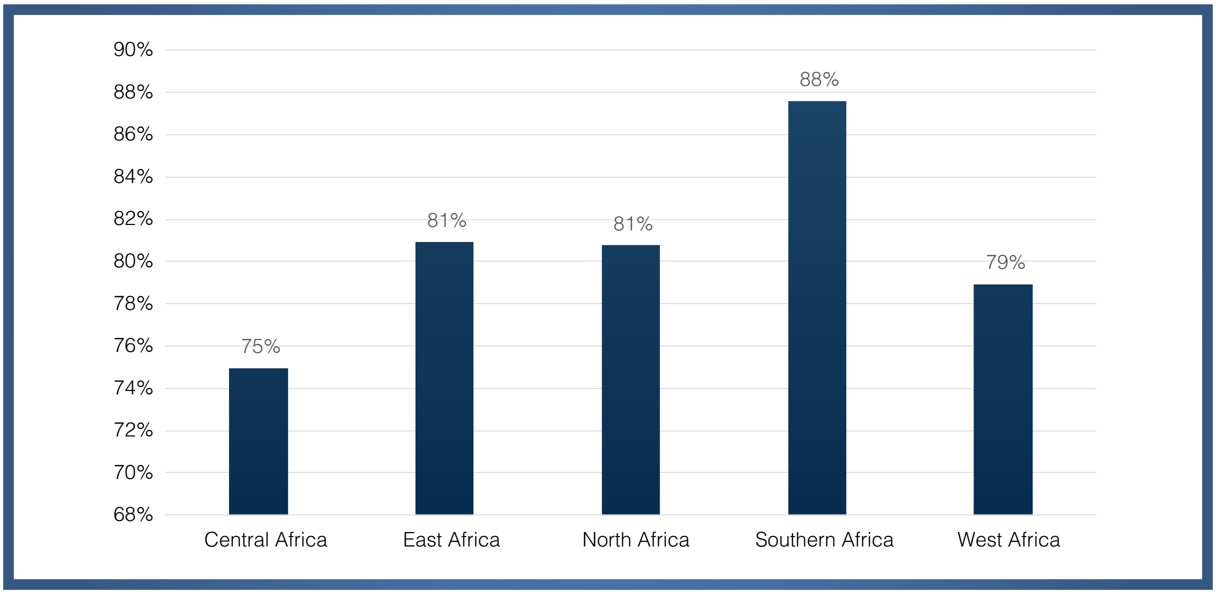
6. Trade Finance Gap in Africa: An Update

6.1 Trade finance approval and rejection rates

Trade finance approval rates have increased significantly over the past nine years, rising by 11 percentage points from 75% in 2011 to 88% in 2019. At 88%, Southern Africa–based banks led the group in terms of approval rates, followed by North and East Africa (81%). Approval rates were lowest in the Central Africa sub-region (75%) (see Figure 22).

Figure 22 – Trade finance facility approval rate, by year and by sub-region

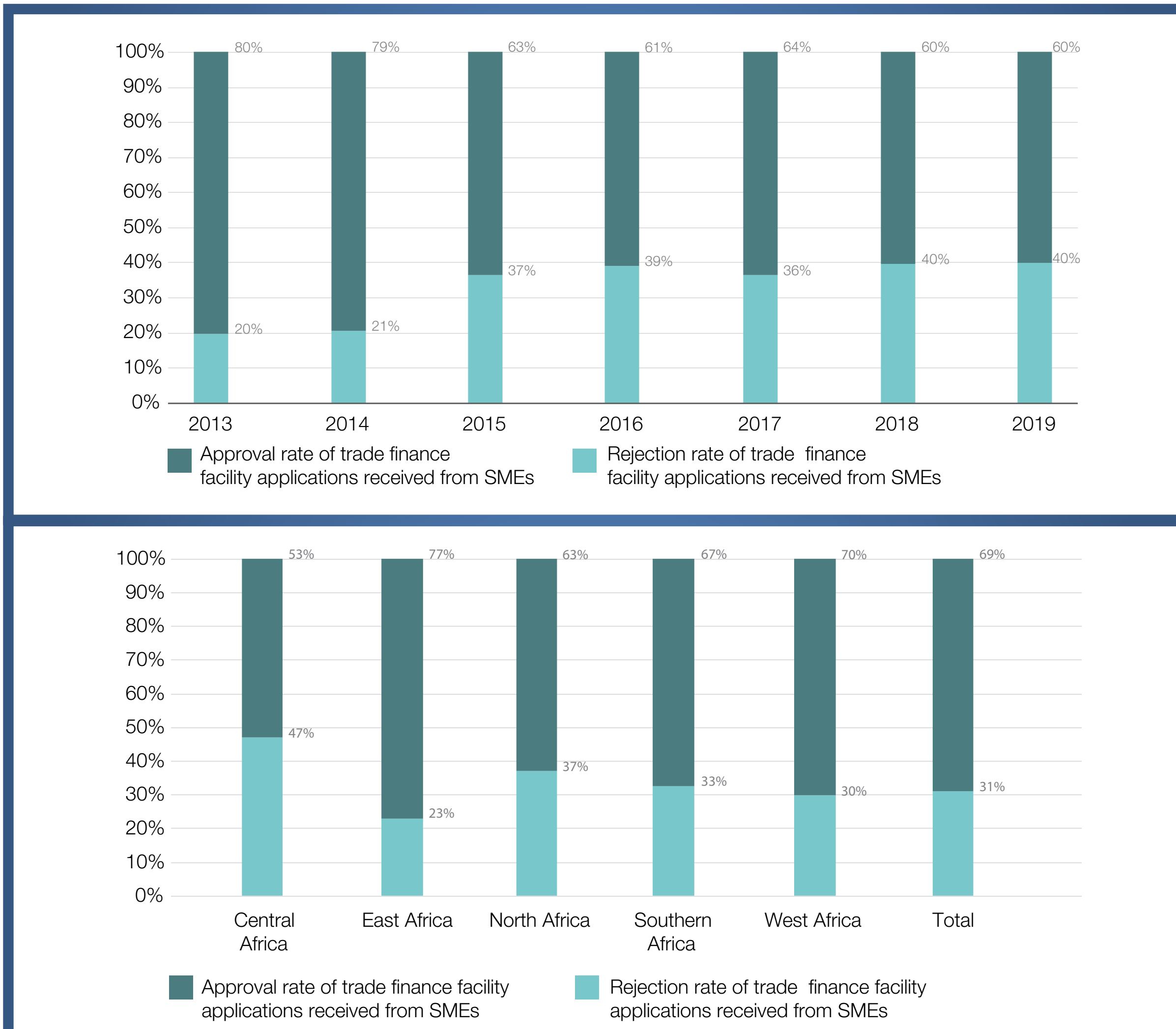




However, approval rates of trade finance applications for SMEs have deteriorated consistently in all years but 2017. The share of SME trade finance applications rejected by banks has increased 20 percentage points from 2013 to 2019. The Central Africa sub-region experienced the biggest shifts – with almost half (47%) of trade finance applications rejected, followed by North Africa (see Figure 23). These were also the sub-regions where confirmation relationships with foreign banks were lowest (see Figure 30), suggesting that declining correspondent bank relationships in those sub-regions negatively impacted SME trade finance applications.

Given that SMEs account for about 80 percent of all private enterprises in Africa (World Economic Forum, 2015), higher-than-average rejection rates for SME trade finance applications are a significant drag on the growth potential for small businesses in Africa. In times of crisis, banks in Africa prefer to lend to large corporations than small firms (Bigsten, et al., 2003; Bigsten, et al., 2003). Hence, as the Covid-19 pandemic continues, banks could face significant foreign exchange liquidity challenges. This could further worsen the rejection rates for SME trade finance applications.

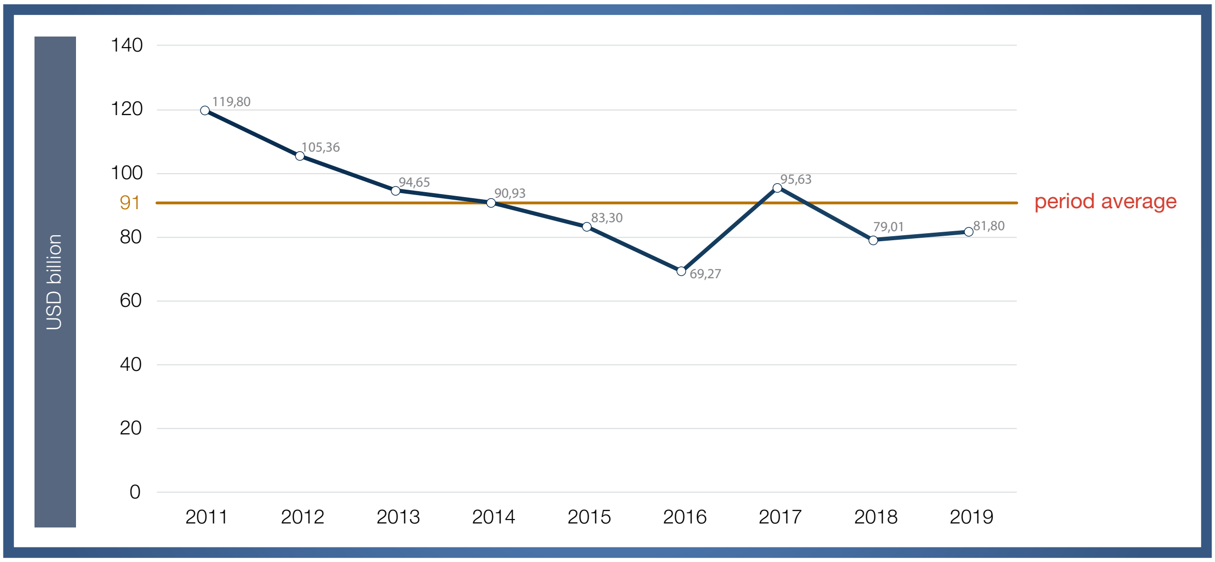
Figure 23 - Average rejection and approval rates of trade finance facility applications received from SMEs by year and sub-region



6.2 Size of unmet trade finance demand in Africa

We provide a conservative estimate of the trade finance gap in Africa for the past nine years and across sub-regions. We pause to note that this remains a daunting task, not least because it is hard to account for why banks reject certain trade finance applications and not others. Indeed, the optimal trade finance supply is not one where every single transaction is approved. Some proposals may be considered illegal under anti–money laundering schemes, while others may merely not meet credit requirement (DiCaprio & Yao, 2017). Notwithstanding these challenges, we use the size of bank-intermediated trade finance in Africa and the average rejection rates by banks to estimate the wedge between trade finance demand and supply over the past nine years. The result is provided in Figure 24.

Figure 24 - Trade finance gap by year



Source: *The size of the trade finance gap (unmet demand) is estimated by dividing the size of bank-intermediated trade finance by the average approval rate and multiplying that by the rejection rate (or 1 minus the approval rate).*

Between 2011 and 2016, the estimated trade finance gap in Africa decreased by an average of 10% a year, reaching its lowest level of USD70 billion in 2016. Perhaps this consistent decrease reflects awareness raised about the magnitude of the gap, not only in Africa but also across Asia. This awareness galvanized a global response from key players in the trade finance industry including DFIs to help close the gap. However, the downward trend has since reversed, and the gap currently remains sizably above its 2016 levels (see Figure 24).

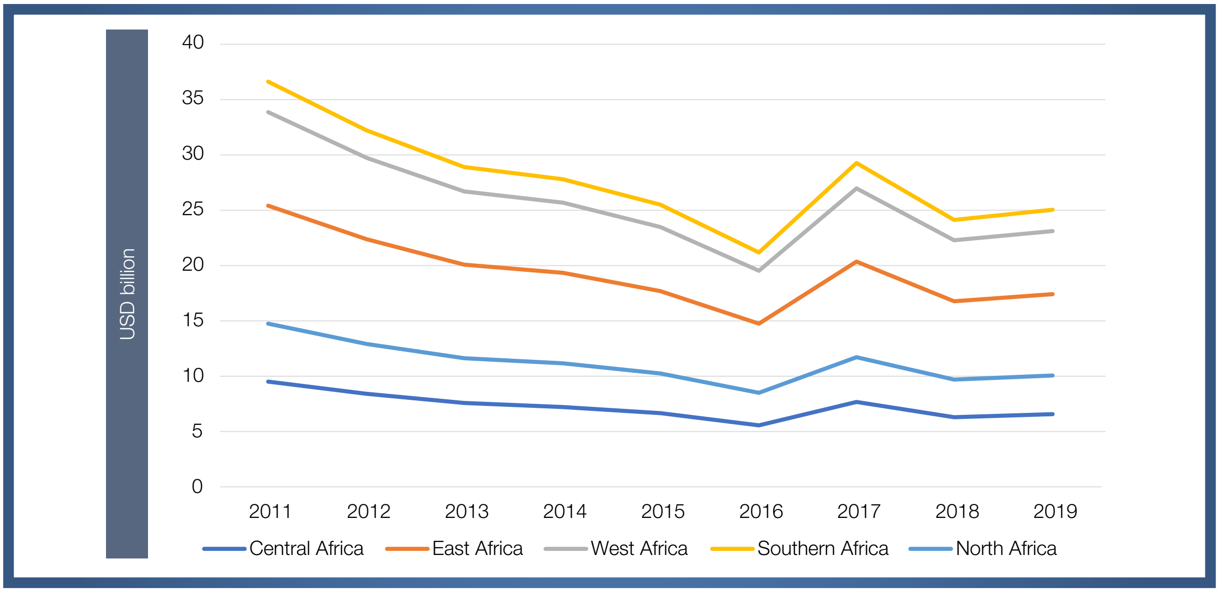
In 2019, a conservative estimate put unmet demand at about USD81.80 billion. Given that total African merchandise trade and global trade finance gap were estimated at USD1031 billion and USD1.5 trillion, respectively (Kim, Beck, Tayag, & Latoja, 2019), unmet trade finance demand in Africa represented close to 8% of the region's total trade value in 2019 and 5.5% of the global trade finance gap. It is worth mentioning that Africa's trade accounts for only 3% of global trade, so its share of the global trade finance gap is disproportionately larger than the region's share of world trade.

Although SME risk profile has improved, SME trade finance application rejection rate has increased by 20 percentage points between 2013 and 2019.

The reversal of the downward trend in the trade finance gap is perhaps not confined to Africa, but reminiscent of the deteriorating global trade finance landscape in general. Recent figures published by BNY Mellon show that trade finance rejection rates are increasing globally, with a third of banks citing compliance and KYC constraints as key drivers for rejection (Mellon, 2019). In the case of Africa, stringent compliance measures have resulted in two mutually reinforcing risks to the trade finance market that potentially accelerate the gap upwards as observed in our survey. New compliance measures have resulted in higher costs of due diligence and also lower margins that have contributed to reducing the number of banks that engage in trade finance activities. Indeed, the share of banks that engaged in trade finance fell from 92% in 2014 to a low of 71% in 2019 - a decrease of 21 percentage points (see Figure 5).

For nine years in a row, unmet demand was highest in West and Southern Africa. Together these two sub-regions accounted for more than half of the total trade finance gap in Africa (see Figure 25).

Figure 25 - Trade finance gap by sub-region in Africa



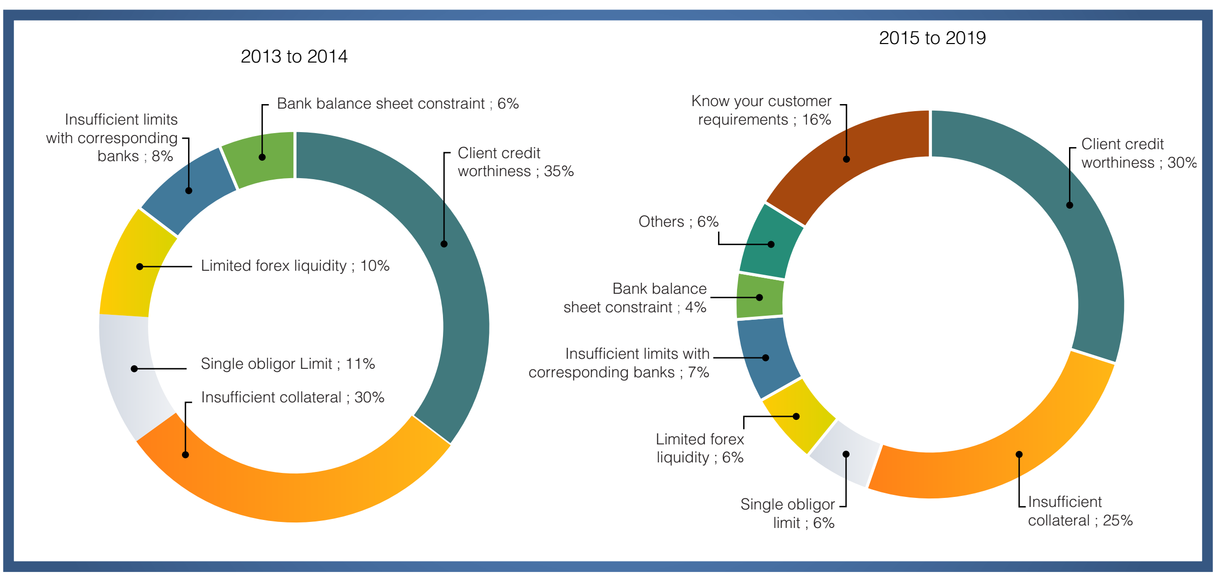
6.3 Reasons for rejection of trade finance applications

> In 2019, unmet trade finance demand in Africa was estimated to be USD81.80 billion. This represents 5.5% of the global trade finance gap. To put this in perspective total African trade represents 3% of world trade.

The reasons for bank rejection of trade finance applications are manifold, but what is clear is that weak client creditworthiness and insufficient collateral have become structural challenges for banks engaged in trade finance activities, and by extension, their clients, too. In the 2013–14 wave of the survey, more than 66 percent of respondent banks indicated insufficient collateral from clients and weak creditworthiness as the main reasons for rejecting trade finance applications. The current wave of the survey shows that more than half (55 percent) of banks – a smaller but still significant share – still indicated these two challenges as the prime reasons for trade finance application rejections (see Figure 26).

The data also shows that compliance with stringent international KYC/AML regulations affect access to trade finance for businesses in Africa. From 2015 to 2019, 16 percent of banks in the survey listed KYC compliance as the third most significant reason for rejecting trade finance applications. This is consistent with findings from a recent survey that identified KYC as the core factor influencing the volume of rejection rate. As regulatory requirements related to KYC/AML have become stringent, banks have become more selective too, moving away from clients that present significant risks for less reward (Mellon, 2019).

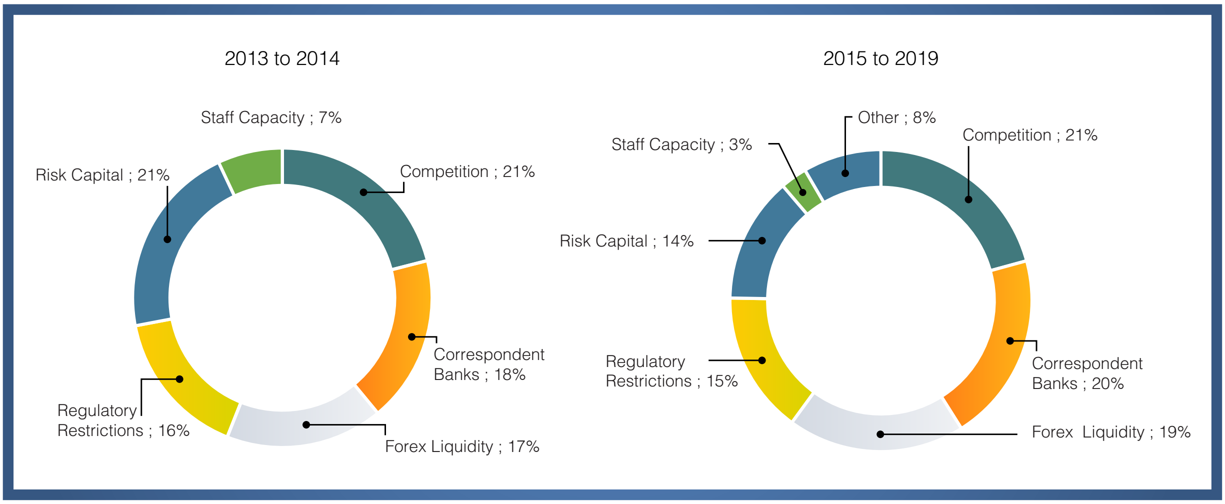
Figure 26 - Reasons for rejecting trade finance applications



7. Constraints to Trade Finance Supply in Africa

To make meaningful progress towards reducing the trade finance gap, understanding the broad challenges facing the industry also matters. Between 2015 and 2019, almost equal proportions (one-fifth) of banks cited competition, corresponding banking, and inadequate foreign exchange liquidity as the main constraints for the trade finance industry. Fifteen percent of banks ranked regulatory challenges as the main constraint. These results follow a similar trend in 2013–14 (see Figure 27).

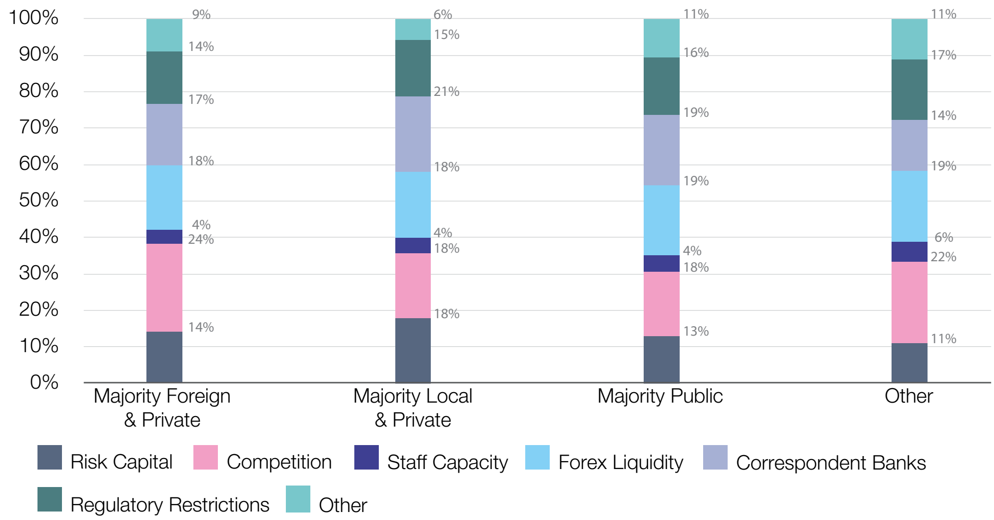
Figure 27- Ranking of constraints to trade finance supply



Regulatory challenges have emerged as a significant drag on trade finance in Africa. 15% of banks list regulatory challenges as the main constraint to expanding trade finance supply.

One possible reason for increasing competition is the growing internationalization of African-based banks across the sub-regions, and the "follow-your-client" expansion strategies adopted by foreign banks to support trading activities of their domestic firms. But increasing competition in the trade finance industry is not necessarily bad news. It drives down transaction costs and diversifies both funding sources and instruments for African firms. In the presence of high compliance costs and low margins due to rising competition, it is not surprising that banks see competition as a significant threat to the growth of their trade finance activities.

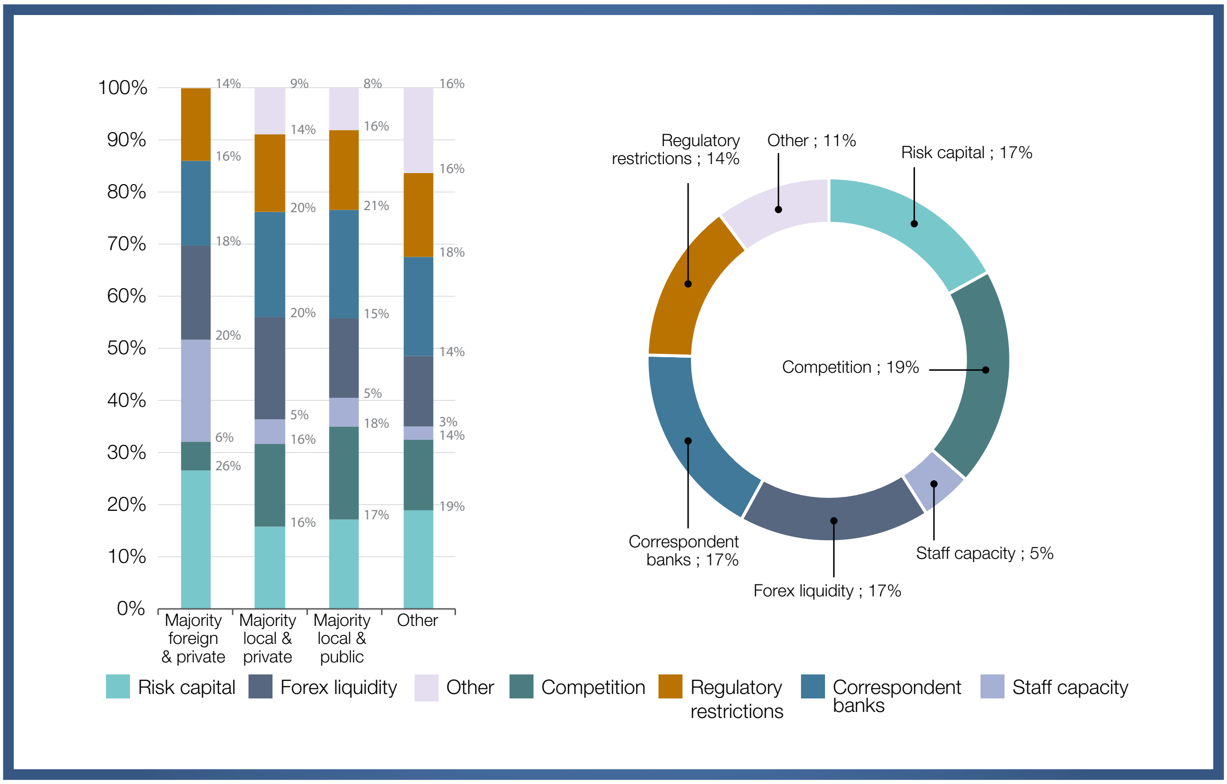
Figure 28 – Constraints to trade finance supply by bank ownership type



More than half of world trade – in terms of value – is denominated in US dollars (Lim, Masquelier, Raymaekers, & Thorsen, 2015) with 80% of letters of credit also being priced in US dollars (International Chamber of Commerce, 2012). Hence, limited access to dollar liquidity presents a challenge for African banks. In addition, the move to adopt new Basel III regulations with higher capital requirements has pushed many international banks to reassess their corresponding relationships with African local banks. When the constraints to trade finance growth are analyzed by bank ownership type, the results largely mirror findings at the regional level (see Figure 28).

The constraints facing intra-African trade finance are not significantly different from those impacting trade finance for other regions of the world. Banks ranked competition as the most significant constraint (19%), followed by foreign currency liquidity, risk capital, and correspondent banking in equal proportions (17%). What is interesting is that only 6% of foreign banks – compared with domestic public banks (18%) and local private banks (16%) – ranked competition as a major constraint, perhaps reflecting the competitive edge foreign banks have over their locally owned counterparts. In contrast, 20% of foreign banks ranked staff capacity as a major constraint whereas only 5% of local banks reported staff capacity as the most significant constraint for intra-African trade finance (see Figure 29).

Figure 29 - Ranking of constraints to intra-African trade finance supply and by ownership type



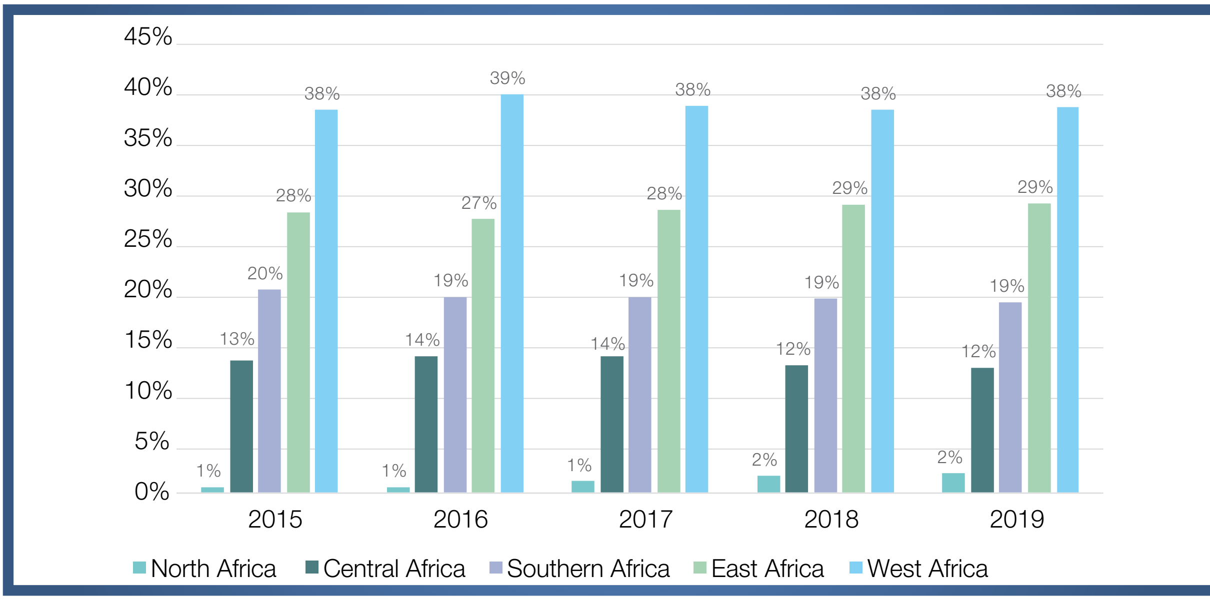
8. Correspondent Banking and DFI Support for Trade Finance

8.1 Correspondent banking and trade finance in Africa

As global banks pull out of markets that are too risky, they leave many African-based banks at risk of not being able to conduct trade in foreign currency. Based on SWIFT data analyses, the number of correspondent banking relationships involving US dollar transactions decreased by about 25% between 2011 and 2017, and by 19% for all transactions for the same period (Financial Stability Board, 2018). Because commodity trade is predominantly priced in US dollars, African trade is particularly vulnerable to correspondent relationships.

Recent evidence shows that there is a general decline in correspondent banking, particularly in emerging markets and low-income economies (World Bank, 2018). We looked at the distribution of correspondent relationships across Africa to understand markets where correspondent relationships are underserved. The survey shows that West Africa on average accounted for close to 40% of all correspondent relationships in the continent, twice the share in Southern Africa (19%) followed by East Africa (27%). North Africa had only 1% of the total correspondent relationships in the region (see Figure 30). It is not clear why North Africa has a significantly lower number of correspondent relationships. Data from the Financial Stability Board (FSB) indicate that Northern Africa has had the highest decline for both US dollar– and euro-denominated correspondent transactions since 2011, at more than 30% (Financial Stability Board, 2018).

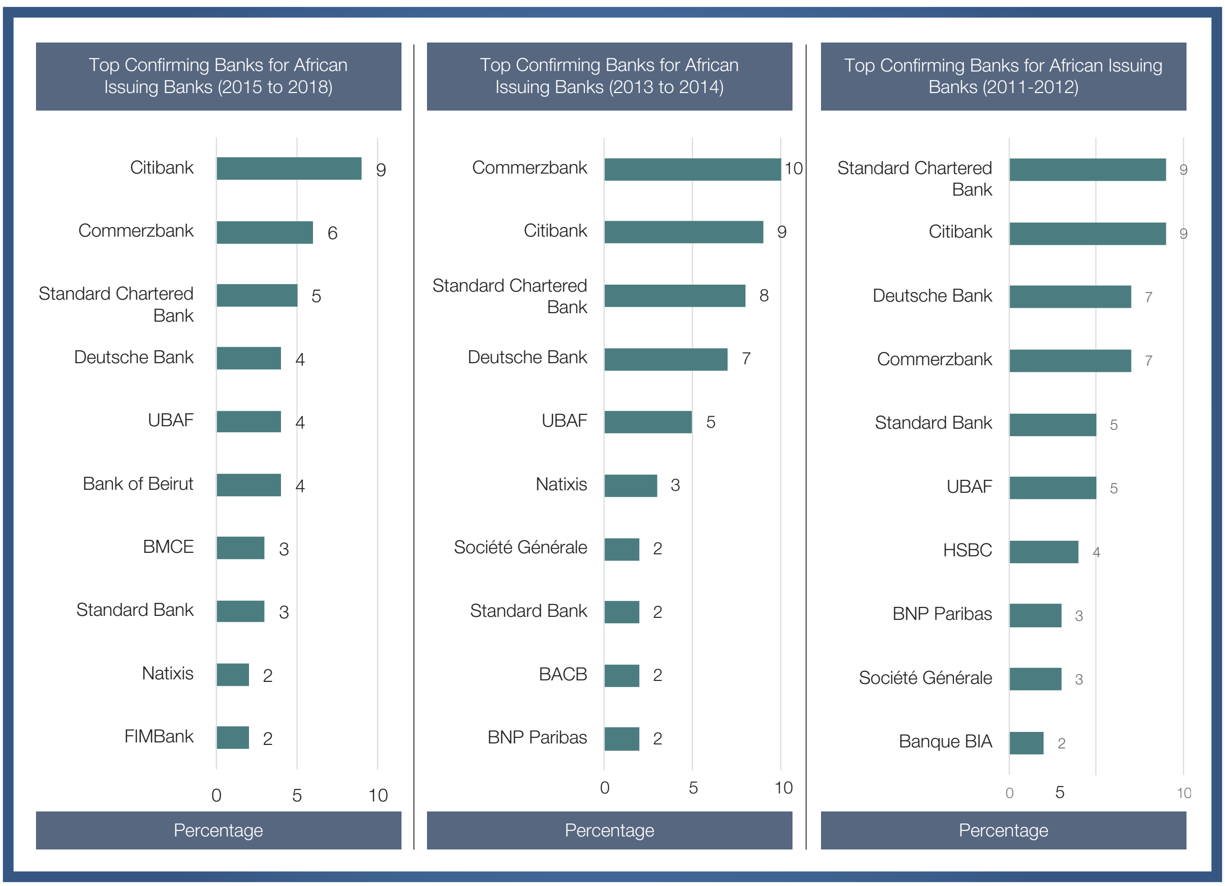
Figure 30 - Distribution of correspondent relationships outside home country by year and sub-region



In each wave of the survey, banks ranked their top confirming banks by value of transactions (excluding their own subsidiaries). Citibank, Commerzbank, Standard Chartered Bank and Deutsche Bank led the pack of top confirming banks for African issuing banks between 2015 and 2019. Citibank topped the list. It had confirmation relations with 9% of African banks. Commerzbank has slipped to second place with 6%, down from first place at 10% in 2013–14. There were also newcomers in the top 10 confirming banks, including Bank of Beirut, BMCE Bank, and FIMBank ranked 6th, 7th, and 10th, respectively (see Figure 31).

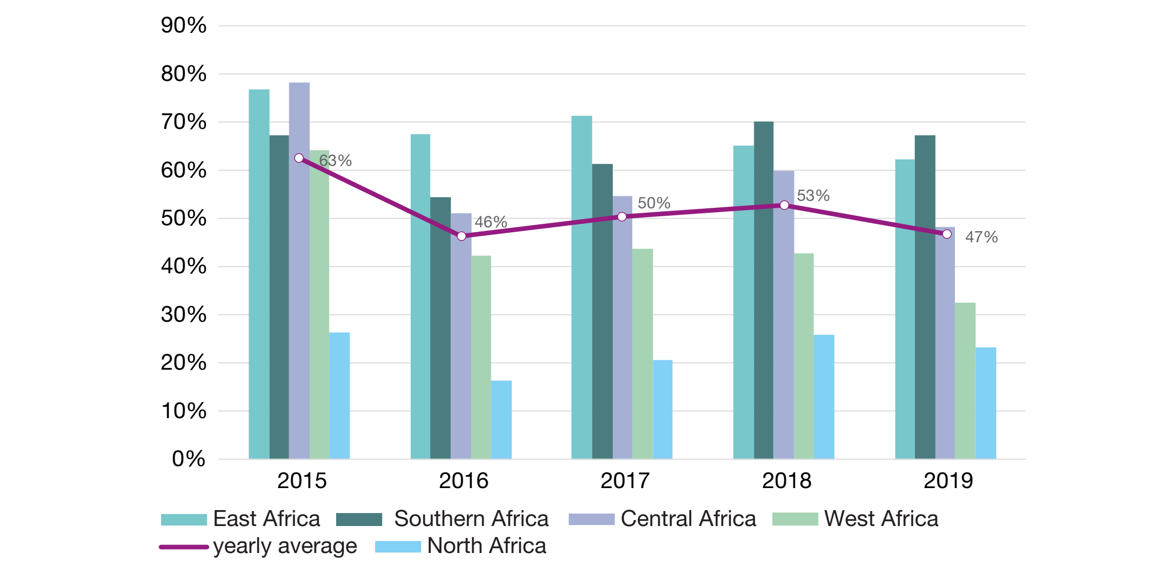
The inclusion of these new banks among the top confirming banks reflects the increasingly important role banks from emerging markets are now playing to fill the gap as more established banks retreat from the region. BMCE Bank of Morocco now has about 560 branches in Africa supporting its trade transaction networks. Similarly, thanks to support through the International Finance Corporation (IFC) global trade finance program, FIMBank has aggressively expanded its corresponding relationships in Africa through its trade finance fund (TFF) program.

Figure 31 - Ranking of confirming banks for African issuing banks



While the top five banks still dominate confirmation activities, there are signs that the concentration of confirmation of trade finance activities among a few banks is waning. In 2019, the top five banks confirmed an average of 47% of total transactions across all sub-regions in Africa, down from 63% in 2015 (see Figure 32). Yet it is worth noting that the concentration of confirmation among a few banks is not unique to the trade finance industry in Africa. Globally, there is some evidence that the biggest four correspondent banks for euro-denominated transactions account for 81% of the total confirmations (Economist, 2014).

Figure 32 - Share of total confirmation by the top 5 confirming banks by sub-region and year



8.2 Development finance institutions and trade finance in Africa

An average of 60% of banks that engaged in trade finance activities received some form of DFI support.

Development finance institutions are increasingly playing a more active role in Africa's trade, often with facilities for short-term lending of working capital and credit guarantees aimed at SMEs. This allows foreign banks to increase their exposure to – and confirmation volumes from – African issuing banks. Since 2013, the AfDB, Afreximbank, and IFC have leveraged their trade finance programs to provide much needed lines of credit and risk guarantees to support African trade. However, until now it was far from clear which sub-regions and banks receive DFI support. For the first time, the survey provides insight about the support received from DFIs in relation to trade finance transactions between 2015 and 2019.

We observed significant heterogeneity across time and bank ownership type in terms of DFI support to African-based banks. West Africa–based banks accounted for more than half of all banks that received trade finance related support from DFIs, although the share had declined from a peak of 64% in 2015 to 46% in 2019. In 2019, Southern African banks accounted for 37%, up from 12% in 2016, while North Africa and Central Africa received 3% each (see Figure 34). This is perhaps not surprising since trade-related DFI support may be inversely proportional to the level of sub-regional development but directly proportional to the volume of sub-regional trade, such that banks based in sub-regions with relatively higher trade to GDP ratios are likely to attract DFI support.

Box 2: AfDB Trade Finance Program: 2017–19

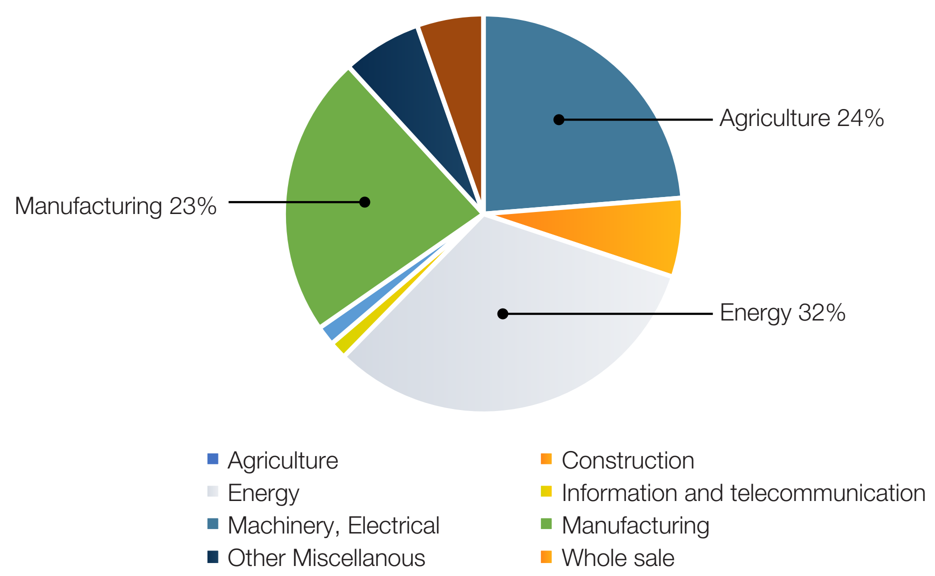
Since the publication of the first Trade Finance in Africa report in 2014, the AfDB has taken significant steps to help reduce the trade finance gap in the region. The efforts made in partnership with sister institutions may have contributed in no small way to lowering the unmet demand from its peak of USD120 billion in 2011 to USD81 billion in 2019. Through its Trade Finance Program, the Bank has approved a total of USD1.4 billion in trade finance lines of credit and USD342 million in soft commodity finance. These have supported an estimated trade value of USD5.5 billion.

Since its inception, the AfDB's Risk Participation Agreement (RPA) program has supported 1,876 transactions for a total trade volume of USD4.8 billion. These transactions involved nine confirming banks located in Asia, Europe, and Africa. Sixty percent of transactions were geared towards SMEs.

About 21% of the support provided was on account of intra-African trade.

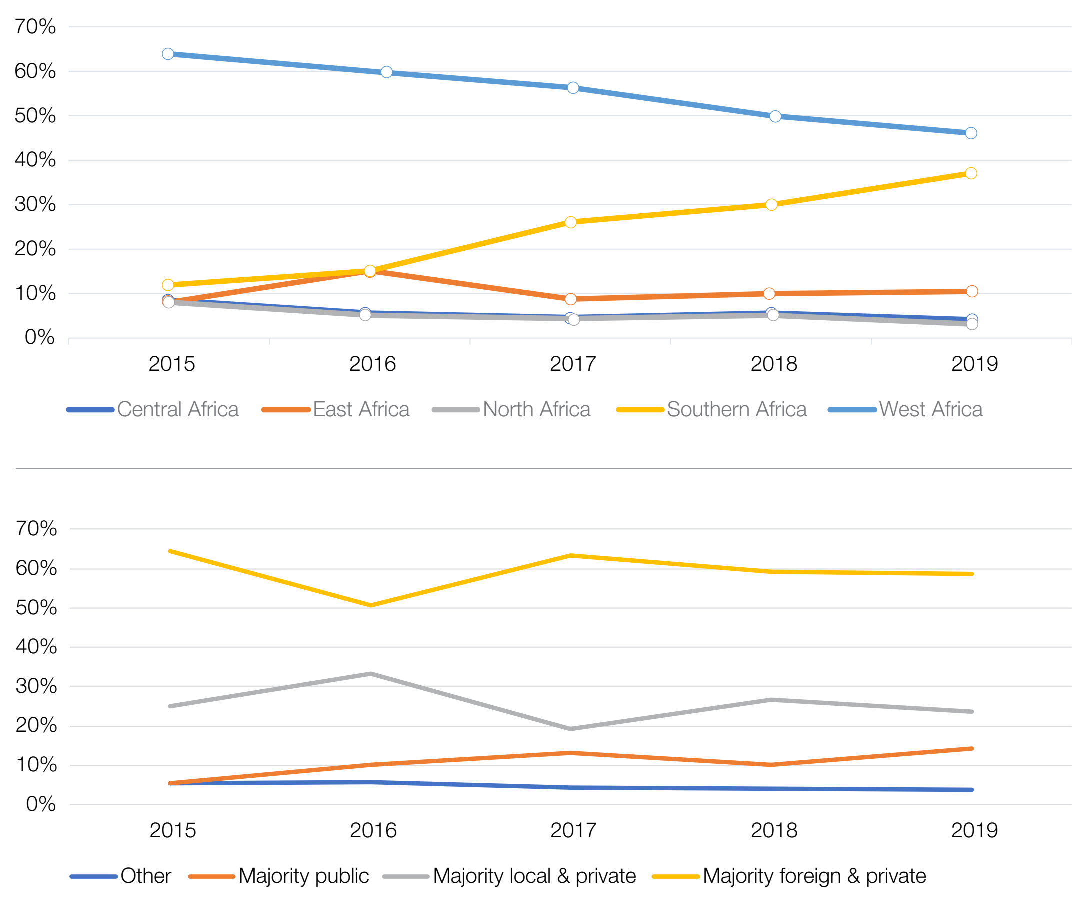
AfDB has also supported trade in its priority areas, including trade in energy-related products (32%), agriculture (24%) and manufacturing (23%) (see Figure 33). With the approval of its USD10 billion Covid-19 Rapid Response Facility (CRF) in April 2020, the Bank is providing up to USD1 billion in trade finance liquidity and risk mitigation support to local banks in all 54 eligible African member countries.

Figure 33- Sector coverage of AFDB Trade Finance Program



DFI support to African banks also mirrored the distribution of bank ownership type in the survey sample (and the size of the trade finance gap by region, see Figure 25). Together, foreign and domestic private banks accounted for 82 percent of all banks that were beneficiaries of DFI trade support programs in 2019. These banks also accounted for 84% of banks that participated in the trade finance business in Africa in the same year. Similarly, public banks accounted for 10% of banks engaged in trade finance in Africa and make up the same proportion of banks that received some form of trade finance support from DFIs.

Figure 34 - Share of banks with DFI support, by sub-region and bank ownership type



Box 3: AFREXIMBANK'S Trade Finance and Trade Facilitation Program (AFTRAF)

The African Export-Import Bank (Afreximbank) offers a comprehensive and expanding range of trade finance programs to finance and facilitate trade, while aiming to support and promote intra- and extra-African trade. The set of Afreximbank's trade finance programs comprise dual recourse programs such as Note Purchase, Receivables Purchase/Discounting including forfaiting, factoring, and invoice discounting. The Afreximbank also offers non-dual recourse programs such as lines of credit (both funded and unfunded) including pre- and post-shipment finance, letter of credit confirmation, and refinancing and direct financing with special emphasis on structured trade and commodity finance. Afreximbank launched its Trade Facilitation Program (AFTRAF) in August 2018 for African financial institutions driven largely by the need to enhance the confidence of counterparties in the settlement of international trade transactions for both intra and extra-African trade. Under the program, Afreximbank offers an uncommitted short-term revolving trade finance facility, which is used interchangeably among five essential products (see Figure 35).

Figure 35 - Afreximbank Trade Facilitation Program (AFTRAF)

The AFTRAF was launched to contribute to the closing of the trade finance gap on the continent. The gap has been partly caused by the withdrawal of international banks from the African trade finance space through a decrease in confirmation lines and withdrawal of correspondent banking on the back of high compliance costs in the context of evolving regulations as well as capacity constraints. Accordingly, the Afreximbank seeks to leverage its credit rating and supranational status to bridge the existing trade finance gap by unlocking capital in support of trade finance business across the continent. Currently Afreximbank has over 350 banks abroad, the AFTRAF program, and over 120 lines amounting to USD2.2 billion spread across 32 countries. The organization's objective is to establish lines in all of its member countries and to on-board 550 African banks to the program.

9. Conclusion and Policy Recommendations

This report presents the findings from the trade finance survey in Africa for nine years leading up to 2019. It reaffirms some of the challenges in the trade finance industry observed in previous surveys and the important role of DFIs in the trade finance landscape in Africa. It shows that the average size of unmet demand remains high at about USD91 billion and only a third of African trade is intermediated by banks. The rejection rate for SME trade finance applications is at an all-time-high of 40% partly due to new regulatory restrictions that have increased compliance costs and decreased margins – making small transactions from SMEs unattractive to banks.

Addressing these challenges will require a concerted effort between various actors in the industry including, but not limited to, multilateral organizations, international and national regulators, and commercial banks. A good starting point is to raise awareness about the challenges new KYC/AML requirements have imposed on banks in the trade finance sector. As economies move to implement new Basel III regulations and stringent anti–money laundering measures, banks have had to set aside more risk capital for foreign transactions, including for trade finance assets, as well as investing more in vetting new clients. In response, fewer banks now engage in trade finance activities and correspondent relationships.

The persistently high and rising rejection rates for SMEs need to be addressed too. The data shows that while the risk profile of SME trade finance assets has improved, the rejection rate on such applications has doubled. The good news is that many trade support facilities – such as the AfDB's trade finance support program, Afreximbank's AFTRAF program, and the IFC's global trade liquidity program – continue to dedicate resources to SME trade. Yet a more flexible approach towards supporting SMEs is still needed if approval rates are to increase. Take the case of state-owned banks, where data show that DFI support has focused on foreign private banks. But in some African economies – including Ethiopia – public banks are the main providers of trade finance facilities for SMEs. Yet such state-owned institutions are sometimes excluded from trade facility support programs (World Trade Organization, 2016). The result is higher fees (see Figure 16) and higher rejection rates for SMEs. DFIs could do more to expand trade finance networks for public banks that support SMEs. In addition, they could increase coverage for SME trade finance applications through risk participation and guarantee programs with commercial banks for SME trade finance applications.

Multilateral development banks now play a more active role in the trade finance industry, but the data shows that support is skewed in favor of banks in West and Southern Africa. Although the survey also confirms that these are the sub-regions where the gap is highest and the need the greatest, it is nonetheless important to address these geographic disparities to boost trade and reduce sub-regional income disparities across the continent. More should be done to increase support for local banks that participate in trade finance in Africa as well.

In the coming years, Africa's trade will experience new challenges and opportunities. The introduction of the new African Continental Free Trade Area (AfCFTA) is expected to eliminate significant barriers to intra-African trade and create a large market for firms across the region. At the same time, the ongoing global health crisis caused by Covid-19 is impacting global supply chains and the region's trade with the rest of the world, while limiting the availability of dollar liquidity to support trade. Thus, once the crisis recedes, the need for financing to reenergize the region's trade will be higher and more urgent. Concrete and urgent steps to reduce the trade finance gap in Africa and address the challenges faced by the industry will be equally important.

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Appendix

Figure 36 - Distribution of respondent banks by country

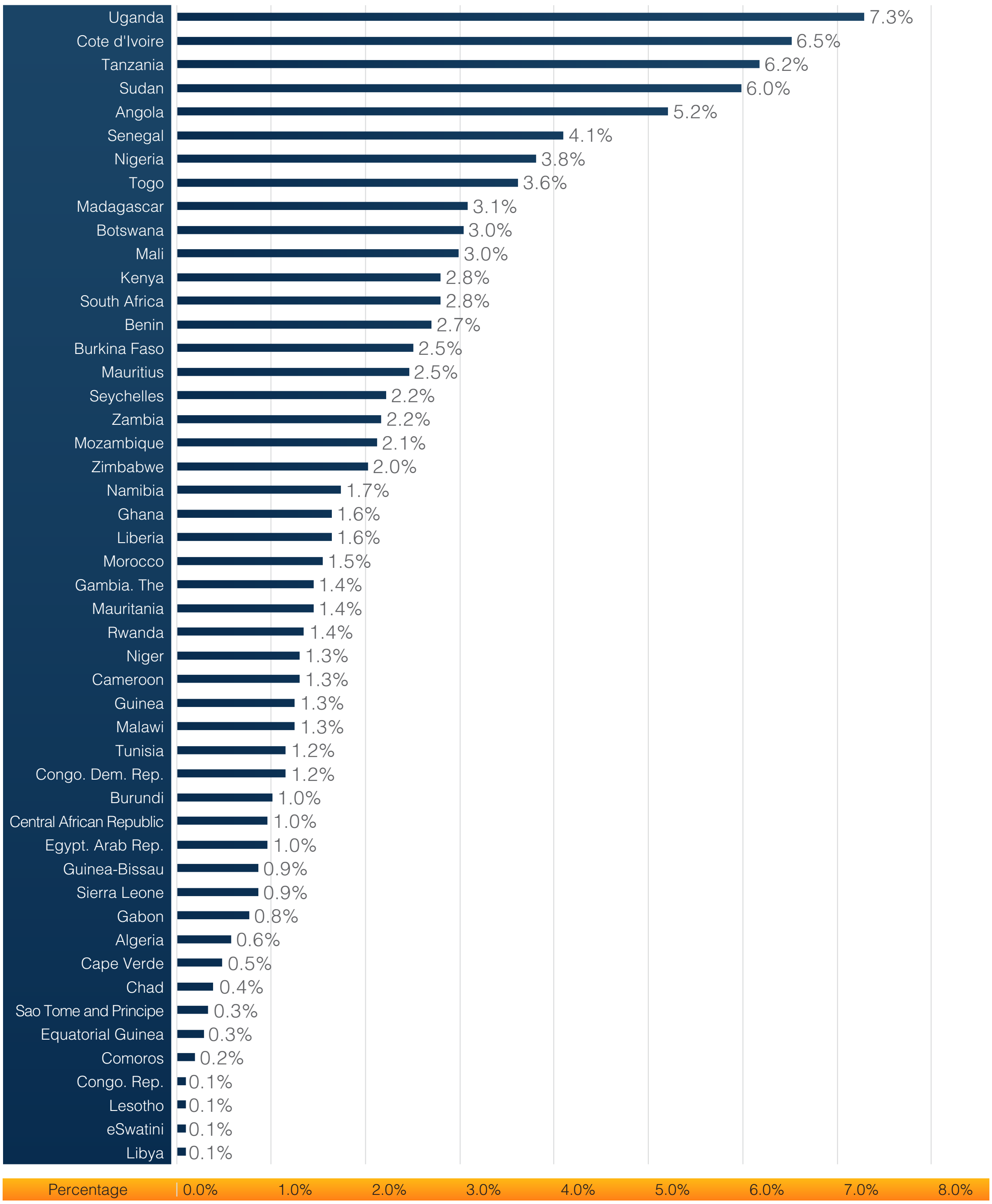

Table 2 - Country breakdown by sub-region

Central Africa	East Africa	North Africa	Southern Africa	West Africa
Angola	Burundi	Algeria	Botswana	Benin
Cameroon	Comoros	Egypt, Arab Rep.	Lesotho	Burkina Faso
Central African Republic	Kenya	Libya	Madagascar	Cape Verde
Chad	Rwanda	Mauritania	Malawi	Côte d'Ivoire
Congo, Dem. Rep.	Sudan	Morocco	Mauritius	Gambia, The
Congo, Rep.	Tanzania	Tunisia	Mozambique	Ghana
Equatorial Guinea	Uganda		Namibia	Guinea
Gabon			Seychelles	Guinea-Bissau
São Tome and Príncipe			South Africa	Liberia
			eSwatini	Mali
			Zambia	Niger
			Zimbabwe	Nigeria
				Senegal
				Sierra Leone
				Togo

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