The African SME Trade Gap, Covid-19 and Practical Solutions

Even before Covid-19, the Trade Finance Gap in Emerging Markets was a hot topic, with a lot of Multilaterals, Governments, DFIs and the larger Global Trade community expressing great concern and a belief that if this Gap could be closed it would be hugely beneficial in developing economies. Micro, Small and Medium-sized Enterprises (MSMEs) trading activities are being obstructed as they are unable to obtain finance and facilities from their local banks and if they could get this Working Capital and Trade Finance, the 30% Trade component of GDP growth and 80% employment that comes from MSMEs would create a Keynesian multiplier to help lift developing economies from within.

Unfortunately, the real underlying mechanics and causes of the African Trade Finance (TF) Gap are not well understood outside the Emerging Markets (EM) Trade community, like the ITFA ARC, who wrestle with this problem on a daily basis. Help and global collaboration is required and this article seeks to demystify these mechanics and root causes with a view to suggesting solutions to improve the situation.

The African Trade Finance Gap

The African Trade Finance Gap was first identified and calculated by AfDB in 2014 and then assessed in the excellent 2016 ICC Trade Survey as $120Bn out of a total of $1.2Tn of African continental trade. Through the ravages of Covid-19 on African businesses and banks, it has probably, at least doubled and the inevitable hysteresis effects, even after the virus has been conquered, suggest that it would continue to widen for a number of years.

The Survey identified that the Trade Gap is comprised of MSMEs not being able to get Credit and financing facilities from their local banks.

MSME Trade Finance and Working Capital in Africa **IS** the local farmers and merchants getting credit from their local banks in their villages, towns and cities on the continent to fund their buying and selling cash conversion timing differentials.

Local African Banks

Only local African banks can practically reach the millions of SMEs across the continent and only they understand them, can assess them and can give them Credit – even when organized into cooperatives and through larger local corporates, it is still the local African banks who can and must provide this trade and Working Capital finance.

There are valiant non-bank fintech, microfinancing, factoring companies and DFI sponsored programmes that look to inject financing directly into developing communities, but these are a drop in the ocean. The sheer physical and geographical scale of the problem means that only the local banks' network of 'boots on the ground' can practically tackle it, even if the facilities are delivered through mobile wallets and other channels.

The Trade Gap existed before Covid-19 because these African banks are being deterred from offering trade facilities to their SME clients due to Global Regulation affecting the relative profitability of trade in terms of Capital and Liquidity costs. The SMEs, on their part do not have the balance sheet size or the collaterals that are typically required by banks for financing purposes. The now infamous inappropriateness of Basel's capital cost treatment of 90-day contingent trade assets as if they were one year, on-balance-sheet debt, despite all the empirical evidence in the ICC Trade Register, is even worse when the underlying obligors are African credit.

These are commercial banks which must do profitable business for their shareholders or die and they will rationally divert finite, scarce capital, liquidity and FX away from SME Trade towards other products that offer better returns than their Cost of Equity – hence the Gap.
African Trade finance has become an unintended casualty of perfectly responsible prudential regulations aimed at Global, Developed World Investment Banks – It just has very harmful side effect for Developing EM Banks in Trade Credit, Capital and Liquidity – the life blood of Trade in Africa.

Tiered SME Banking
Not all local African banks are the same. They are tiered from the largest, systemically important Tier 1 banks (sometimes with significant Government ownership) who bank the multinationals and better local corporate businesses and operate internationally, through the medium Tier 2s and 3s who bank the mid-corps, SMEs and MSMEs. Although most African banks will have an SME book, often the majority of MSMEs and start-ups will bank with the lower tier 2s, 3s retail or business banks and microfinance institutions. Often they will need to offer any collateral they can to secure WC overdrafts and trade facilities – homes, farms, shop buildings, machinery, stock, etc.

Tier 3 banks' Treasuries will necessarily rely on Tier 1s and 2s for capital, liquidity and FX for their trade books: The Tier 1s and 2s can effectively act as aggregators of the lower tier MSME trade books without looking through to their underlying credit and security.

African Trade USD Liquidity
For domestic, local currency trade and WC facilities this is naturally constrained by the capital returns and liquidity restrictions and finite inter-bank credit risk limitations but for any cross border or commodity trade, denominated in US dollars, a whole new set of costs and problems ensue.

African banks, often in Exchange Controlled countries, suffer extremely high cost of funding hard currencies, particularly USD. Their Central Banks often aren't able to maintain sufficient foreign currency reserve cover to meet their USD denominated import requirements as their economies don't generate enough USD exports, partly because most of the economies are commodities – dependent for exports and FX reserves generation. This creates shortages and pricing inflation for FX liquidity, devaluations, spiralling sovereign risk premiums and a reluctance for international banks lending wrong-way risk dollars to their commercial banks. This results in withdrawal of some international banks from Africa thereby leading to liquidity squeeze especially during turbulent moments like the one during the Covid-19 pandemic.

Cross border African trade finance is typically funded in USD: the international exporter wants to be paid dollars immediately they perform at sight and the African importer needs three to six months or more to receive, condition, distribute, and sell the goods in local currency, requiring their local African bank to fund USD for the tenor of the underlying cash conversion cycle.

When the African banks attempt to fund these short-term trade dollars, they inevitably find their returns as lower than their cost of equity and value destroying as their net margin, after the inflated cost of funding, over the Basel 2 inflated capital RWA costs the regulations force them to hold against their poor credit quality African corporate and SME obligors, renders the business even more unprofitable.

This is exacerbated by the Basel 3 liquidity regulations flattening the shorter end of the dollar liquidity curve and/or their Central Banks levy 'Statutory Reserve Costs' to protect local depositors. Even if dollar clearing banks will lend short-term dollars to African banks trying to fund their trade books in the Money Markets, the LCR, NSFR, and HQLA costs make it so expensive, their Treasuries might as well use five year Syndicated Loans or Eurobonds to fund 60-day trade transactions. This is unsustainable and a further contributor to the Trade Gap.

African Trade Refinance
Fortunately, there is a species of Trade lending from international banks and DFIs to African banks which can significantly improve the cost of shor- term, dollar trade financing which can considerably improve the net revenue and the returns on the trade assets to profitability.

Under Basel 2 AIRB (Advanced) methodology, sophisticated lending international banks can use lower Loss Given Default (LGDs) for assets designated as 'Trade', this results in considerably lower RWA Capital costs, the benefits of which can be shared with the EM borrowing banks in lower pricing. (By the way, Basel 3.5/4 will remove this LGD enabler in 2022…)

Also, USD 'Trade' financing is not technically deemed to be 'wrong way risk' as it involves a self-liquidating, real flow of hard currency denominated goods into the country.

Unfortunately, 'Trade Refi' can only usually be used for large, lumpy, long tenor assets as, to qualify as 'Trade' and receive the LGD relief or DFI liquidity, the borrowing bank must 'prove' it is re-financing 'Trade' by rendering up all the details of the transaction: importer, exporter, goods, origin, tenor, shipping, ports, nominal, etc, etc and sometimes even copies of some or all of the underlying documents.

This is just completely unusable for the vast majority of real MSME trade finance: there are huge numbers of very small, very short tenor, randomly drawn and maturing and revolving assets which all have to be funded at uneconomic, unprofitable rates out of the EM banks' Treasuries and they are impossible to refinance because the ballistics of these assets make the information marshalling and administration required by the lending banks to prove they are 'trade' completely impossible.

The Tide of African De-risking
Due to the political instability, risk of huge Compliance and AML fines, history of defaults, Credit rating downgrades, cross-border enforceability and associated costs over the course of the last decade, many international banks and investors have de-risked out of Africa. Bilateral RMAs with African banks, even Tier 1s have been shut down and Credit and Financial Crime Compliance Departments, the World over have responsibly declined to travel to, assess, do EDD and sanction limits and relationships in the 55 African countries.

While this de-risking started after the Global Financial Crisis and African trade credit appetite has ebbed and flowed over the last few years, we observed a sharp contraction of international investor appetite with the onset of Covid-19. International banks withdrew their credit and liquidity from the primary market and the secondary trade market snapped shut.

Fortunately, the DFIs and Multilaterals (many of them who populate ITFA and ARC) came to the rescue with their Covid-19 response trade programmes and helped with direct government and commercial banks guarantees, loans and risk participation programmes' credit support and USD liquidity. Unfortunately, MSMEs can't benefit from even this support for structural reasons.

DFI and Multilateral Trade Programmes
Governments, DFIs and Multilaterals are genuinely desperate to extend their developmental aid into African Trade and Working Capital. Intuitively, it fits their mandate perfectly but they are, unwittingly, structurally unable to extend this aid to African MSME Trade and Working Capital.

Their Trade programmes generally are repurposed debt technology guarantees or loans which work well for low volume, large, lumpy, longer tenor assets but completely unsuitable for the millions of ephemeral, high velocity, tiny real MSME trade and working capital facilities in Africa.

There are three problems:

1. **Evidence and data:** this is the crux of the problem – All international investors but particularly the DFIs have very strict evidential conditions: they MUST know ALL of the dimensions of every underlying transaction they support. Their boards and governments demand that they prove the legitimacy of every trade dollar and they increasingly need to prove their Green and social responsibility credentials with exacting ESG conditions. This is very sensible and completely understandable given all the abhorrent corruption, crime and environmental and social harm and suffering, aid dollars must not bank roll. It just fundamentally doesn't work for MSME trade as the data burden is just too much for the true nature of the assets and the institutions that originate them. Trade processing in Africa is analogue, manual, physical and paper based;

2. **Time:** the funding is required by the MSME before all the Institutions in the chain can prove its legitimacy and the millions of assets' creation and maturity are randomly distributed in time, on a continuously revolving basis;

3. **Size and tenor:** DFIs in particular but also other large institutional investors simply don't have the Treasury resources for small, short facility execution. DFIs can only give two or three year 'trade' facilities of tens or hundreds of millions of dollars. This leaves the African banks with a fatally unviable tenor and quantum, asset and liability mismatch problem if they try and fit them to the shape of real MSME African trade and working capital.

SME Trade Bank Aggregator Chain

The DFIs and International Institutions don't have the reach or resources to reach the African local banks' MSME books. Instead, the Tier 2 and 3 banks' SME books can be aggregated with the Tier 1s. ITFA ARC is on an acquisition drive to bring as many African banks into the ITFA community as possible to promote this kind of activity.

The African Regional and Multilateral banks can, in turn, act as aggregators of these African Tier 1 trade books, who can then form portfolios of real SME trade and working capital assets that can be underwritten and financed by Global DFIs and Institutional Investors.

The data and timing problems in this accumulation chain are multiplied and compounded on each of the four layers of accumulation which takes the conditional granular evidential demands of Internationals and DFIs completely impossible. Unless we resolve the data problems listed above, closing the Gap, which is now widening through Covid, will remain forever intractable, a vain hope and podium talk…

Digitalization

Where there is a will there is a way. If closing the EM MSME trade Gap is really a priority to the international community, we have the necessary tools and technology to solve it. Given our experience, hoping that Basel will recognise the empirical risk profile of trade finance to make it viable business for EM banks and DFIs and International investors will delimit their evidential requirements to the absolute safe minimum is Panglossian and silly.

We have a data problem and the answer to that data problem must be digital. Although we have all the tools readily at our disposal (inevitably blockchain), we will all need to collaborate and invest to apply the digital solution to where it is needed right back at the start of every MSME trade and working capital facility application to the their African bank. The data capturing and curation must be 'digitally native' as the African Tier 3 bank books the MSME asset in their risk systems, flagging it in an api or, at worst dual-keying all of the required data into a cloud-based qualifying portfolio, at inception.

Hoping that the African banks will spontaneously develop this digital tech from the developing ground up is daft. Instead collaboration between the DFIs, Banks, Insurers, Fintechs, and Global IT firms and Trade community would be the only realistic source of the required investment, resources and technology. It could be a fitting manifestation of Global IT companies, like the FAANGS, and NGOs social responsibility and Aid agendas, working in concert with the Global Trade communities, like ITFA.

Securitization

Although this is a 'dirty word' after the GFC, 'securitization' technology, matched with the proposed digitalization, is perfectly suited to bundle MSME trade assets into portfolios that DFIs and International Investors can get their hands around. They can be put into SPVs, tranched, notes could be issued off programmes and conduits to raise USD that can be used to 'feed the beast', creating new SME trade assets perpetually into the future, as the programmes become self-sustaining.

Importantly, DFIs and Reinsurers could boot-strap the process through first loss underwriting of the portfolios, secure in the knowledge that they were directly addressing MSME trade mandates in Africa by using their existing guarantee and risk participation tool sets. With their AAA wrappers, tenor matched USD liquidity could be provided by international banks, funds and real money investors, solving the fittingly tenor matched pricing of problem 3. It will require this 'leap of faith' to solve the timing problem 2 to kick-start the process without the retroactive evidence the DFIs normally demand.

This underwriting wouldn't need to be restricted to the USD cross-border trade asset pools. The domestic local currency facilities could be guaranteed in USD, EUR or RMB with appropriate FX haircuts and made available to Global investors. This would allow for the capture of the entire Gap, not just the cross-border trade.

Because all the asset data has been captured at source, portfolios can be tranched, sliced, diced or co-mingled into geographical or even facility flavours to suit the investors' mandates.

New EM Trade Asset Class

There isn't enough capacity in the DFIs and multilaterals alone to close the now $200Bn and growing Gap in Africa alone. However, if the process could be boot-strapped by the DFIs as outlined, a new investible EM Trade asset class with empirically low default rates, paying EM yields, orthogonally diversified from the rest of the market. It could be an ideal uncorrelated investment asset class in Global investors search for yield, at the same time as fulfilling the capital and liquidity to completely close the Gap.

Performance

Enticingly, this species of EM Institutional trade finance has demonstrated remarkable risk resilience, even through-the-cycle of the chaos of the pandemic and GFC. It evidences **MUCH** better default performance than traditional corporate debt and even trade. It doesn't suffer from the fraud that besets, corporate, commodity trade finance that has recently blown up in Asia and Dubai and forced some international banks to book huge impairments and rethink their commitment to trade. It avoids the perennial Structured Commodity Trade Finance perilous reliance on African collateral managers and traders and liquidating physical commodities and stock.

All the evidence suggests that African banks don't default on trade. The systemic banks are effectively underwritten by their governments and the trade of lower tier banks and the governments themselves are effectively underwritten by Multinationals and DFIs. Even scarce FX liquidity is prioritized for trade as governments comprehend its preeminent importance for their economies and societies' future.

Counter-intuitively, FI Trade's independence from the underlying SME or Corporate performance and absolute reliance on the irrevocable obligation of regulated, transparently performing Financial Institutions, dramatically improves the asset class' actual default risk.

Understanding, Vision and Practical Implementation

We believe that once the mechanics of the problem are properly comprehended by the whole community who have volubly expressed a true desire to help and resolve the problem, the Trade Gap can be closed to the benefit of hundreds of millions of people across the Emerging Markets. All it will take is, hitherto unparalleled collaboration and realignment of already available resources from the Global Trade, DFI and Tech community. This formula, practically implemented, could be the catalyst to deliver the promise of the AfCTA and close the African Trade Gap.