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Factoring: An Alternative SME Financing Instrument for Intra-African Trade Promotion

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Abstract: Small and medium enterprises (SMEs), which constitute the largest proportion of Africa's industrial fibre and are set to be key actors during the implementation of the African Continental Free Trade Agreement, continue to face major constraints in accessing financing. This paper highlights the development of factoring and supply chain financing (reverse factoring) as viable alternative financing instruments for the growth and development of SMEs at a time when closing trade financing gaps will be critical to the expansion of intra-African trade and effective implementation of the trade pact.

Keywords: AfCFTA, factoring, Intra-African trade, SME financing

1. Introduction

Small and medium enterprises (SMEs) contribute significantly to the economic fortunes of countries around the world, especially developing countries. They create jobs and contribute to the growth of gross domestic product and economic development.[1] SMEs account for 80% of firms in Africa and make up the largest proportion of the continent's industrial fibre. Notwithstanding the documented contribution of SMEs, limited access to financing is a major constraint to their growth and expansion. The challenge is more pronounced in Africa, which is characterised by a significant financing gap across all sectors. Lack of access to financing could present a major challenge to the implementation of the African Continental Free Trade Agreement (AfCFTA).

Trading under the free trade agreement was expected to commence on July 1, 2020, but was postponed to January 1, 2021, because of the COVID-19 pandemic. Once trading commences, the agreement is projected to usher in a new era of African trade with

1. In view of the frequently contextualized definition of SMEs, this paper approaches SMEs from a generic perspective.

the potential for greater exchange of value-added products, which would contribute significantly to unlocking Africa's economic potential. Availability of trade financing, especially for SMEs, will be the key lubricant to propel the agreement to realise its objectives. It is estimated that an additional US$40 billion in trade financing will be required to meet the expected increase in demand for financing associated with expansion of intra-African trade under the new trade pact.

In view of the expected dominant role of SMEs in ensuring optimisation of the gains associated with the free trade agreement, access to financing will become even more critical. This paper discusses factoring as a viable alternative source of financing for SMEs. The rest of the paper is organised as follows: Section 2 discusses challenges with SMEs financing in Africa. Section 3 reviews factoring as a tool for SME growth in Africa. Section 4 discusses implications for intra-African trade, and Section 5 concludes.

2. Challenges with SME financing in Africa

Trade financing is critical for the facilitation of cross-border trade because of its role in overcoming the challenges of information asymmetry, contract enforcement and liquidity constraints inherent in international trade transactions. Africa has a high unmet demand for trade financing, with an estimated annual trade financing deficit of US$81 billion (AfDB and Afreximbank, 2020). At less than 3%, Africa's share in global trade is dismally low, partly reflecting the constraints faced by SMEs in their growth and development. Limited access to financing, especially by SMEs to be able to meet their financial needs, undermines their ability to grow.

The withdrawal of major international banks from the African correspondent banking and trade finance landscape in a context of increasingly stringent regulatory environment and high costs associated with compliance and anti-money laundering (AML) issues has exacerbated the financing gap faced by African entities, especially SMEs. Although banks currently support one-third of Africa's trade, only 28% of banks' total trade finance portfolio benefits SMEs. The average rate of rejection of letters of credit, which is a key instrument used by banks to finance trade in Africa, is estimated at more than 6% (AfDB & Afreximbank,2020; Gajigo et al., 2015; Bérenger, 2018).

Several factors account for the difficulty faced by SMEs in accessing trade finance. Financiers first and foremost cite the inability to assess the creditworthiness of SMEs as a key challenge in providing them with credit. Indeed, creditworthiness is one of the key elements of a bank's underwriting processes, but it is difficult to ascertain especially where credit ratings are not standard. In advanced economies, the lender would usually expect the contract between seller and buyer to be enforced since reneging on such contracts would adversely affect buyer's credit rating. In the absence of such safeguards, trade finance for SMEs has an added element of uncertainty, even though trade finance on the continent is less risky than other types of lending. The default rate on trade finance in Africa is estimated at 5% compared to 12% for non-performing loans for all bank asset classes (AfDB, 2017).

Another obstacle is the informality of SME trade and the absence of structured bookkeeping processes. Most SMEs across the continent lack proper organisational structures and do not meet global standard on record keeping and bookkeeping. In this context, relevant information about them is usually scant and unreliable.

Inflexibility on the type of collateral required by lending institutions constitutes another barrier to trade finance for SMEs. Collateral requirements in Africa can be as high as 100% of loan value. In most cases, they are limited to cash, fixed assets and guarantees, among others. Most banks are not open to considering the goods traded or the receivables of the contracts financed as their collateral on a stand-alone basis. Hence, SMEs that often pledge all their assets to one bank to receive a term loan or overdraft facility are then limited when applying for trade finance or working capital, as there are no more assets available to pledge. Furthermore, some small traders who lease warehouses do not have large assets to offer as collateral.

Another key factor is the constraint of single obligor limit often faced by local banks and other trade finance entities. However, SMEs often require large amounts of short-term liquidity to finance bulk purchases, especially when prices are low. Under such circumstances and from a balance sheet perspective, local banks face restrictions and are unable to provide sufficient liquidity to a stand-alone client.

Other factors that affect African SMEs and large corporations alike when seeking trade finance include the absence of credit insurance and de-risking mechanisms that exist elsewhere, political risk, which is exacerbated during cross-border transactions, and currency risk.[2] Furthermore, over-inflated risks preparation, as well as limited access to capital markets for the overwhelming majority of African SMEs, hinder their ability to draw on diverse sources of funding to expand African trade (see how currency risk management can boost access to trade finance in Africa in this issue

2. Currency risk in trade finance relates to lenders' concerns about their funds getting stuck in a country where they do not operate, the fear of currency devaluation, or a shortage of foreign reserves, posing transferability and convertibility risks that may result in a lack of payment.

> Most SMEs often have no capacity for self-financing and therefore cannot finance the top of their balance sheets and working capital requirements.

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All these factors contribute to SMEs' lack of access to traditional banks and other formal financing sources. Both supply and demand factors explain the limited use of banking services by SMEs. On the supply side, market imperfections, characterised by information asymmetry or weak creditor protection, make it difficult for financial intermediaries to assess the creditworthiness of SMEs, monitor their activities and enforce repayment. On the demand side, lack of creditworthiness makes it difficult for SMEs to access financing. In general, the supply side constraints are more prevalent.

Increasingly, banks are becoming more reluctant to provide loans to SMEs since they typically have very low levels of capitalisation, on the back of sluggishness in their economies. These factors impede SME development and operational performance, thereby limiting their ability to increase their capital. At the same time, most SMEs often have no capacity for self-financing and therefore cannot finance the top of their balance sheets and working capital requirements. In view of these constraints, they are hesitant to approach banks for loans. In this context, factoring is seen as a viable alternative financing source for SMEs.

3. Factoring as a tool for SME growth in Africa

Klapper (2006) and Vasilescu (2010) describe factoring as a financial service where an enterprise sells its accounts receivable (in the form of invoices) to a factor at a discount in exchange for immediate cash and a range of services, including credit protection, accounts receivable bookkeeping, collection services and financing. It is recognised as an alternative and globally well-established source of financing suitable for SMEs (Ivanovic, Baresa, & Bogdan, 2011; Vasilescu, 2010). Unlike traditional loans, factoring is particularly compelling and effective for SMEs, as underwriters place the risk mainly on the receivables (the financial asset) and the creditworthiness of the buyer rather than on the seller (usually SMEs) (Vasilescu, 2010).

In cases where the buyer is situated in a different country from the seller, two factors should be involved – one in each country. The correspondent factoring relationship anchored in Factors Chain International (FCI)'s two-factor system provides the necessary safeguards, as in the quadrant involving the following parties: the exporter, the importer, the export factor and the import factor. The two factors establish a contractual or correspondent relationship to service the buyer and

A two-factor system, under the aegis of FCI, allows the national factor to grant financing, with the corresponding factor ensuring collection abroad.

the seller, respectively. Therefore, to carry out import activities freely, the importer needs to sign a factoring contract which allows it to outsource the management of its transactions. It also helps to maintain business at a high level of performance while remaining credible with suppliers.

Once the goods are released, it becomes the responsibility of the factoring structure to ensure proper delivery of the order. It will therefore have to ensure the transport of the goods, insurance and the warehouse so that they are truly delivered to the end customer. A two-factor system, under the aegis of FCI, allows the national factor to grant financing, with the corresponding factor ensuring collection abroad. Factoring enables firms to have better solvency ratios, better supply chain reputations given the timely meeting of company obligations, and improved sales volume given an increased ability to offer trade credit (Ivanovic et al., 2011). Moreover, some firms may benefit from their fixed assets not being encumbered, better terms for export, reduced bad debt and exchange risk, improved profitability due to reduced credit risk, and reduced leverage and worries associated with being over-leveraged (Ivanovic et al., 2011).

An international factoring mechanism involves an international trade contract with factoring activities between an import and an export factor (Vasilescu, 2010). The export factor benefits the factoring transaction by way of local market knowledge, local presence and local language skills (IFG, 2012). The parties to a domestic factoring – the client, the factor, and the debtor – are usually in the same jurisdiction (IFG, 2012).

There are two instances of factoring: recourse and non-recourse factoring. Non-recourse factoring offers a client full credit management service cover on approved debts against the eventuality of being unable to secure full payment of factored invoices (Vasilescu, 2010). Under recourse factoring, the factor takes responsibility for debt collection but retains the right to seek full recourse from the client for any bad debts (Vasilescu, 2010). There is also reverse factoring (supply chain financing) whereby a factor offers suppliers of a debtor the option to assign or sell their debtor-approved receivables. With a guarantee from the debtor while in invoice discounting, the financier purchases the sales ledger and advances funds against the approved debt but does not take on the responsibility for the debt collection (IFG, 2012).

The African Export-Import Bank (Afreximbank) recognises the important role of SMEs on the continent in terms of industrial development and structural transformation, as a response to growing local demand for services, increased specialisation and support for large companies through backward and forward linkages. Given their contribution to the fortunes of developing economies, there is an urgent need to offer SMEs adequate solutions to optimise access to financing to enhance their participation in intra-African trade. Accordingly, Afreximbank has identified factoring as one of the most effective financing instruments to support SMEs. They can play the role of indirect exporters within logistic chains of export, with the hope that factoring will lower the cost of funds and allow small businesses in African countries to be more competitive through the use of open accounts other than letters of credit.

In view of this, the bank has designed and implemented a five-pillar strategy consisting of financial intervention, development of legal and regulatory frameworks, awareness creation and capacity building, services, and strategic partnerships. To support this strategy to facilitate an increased contribution of SMEs to integrated regional supply chains, the bank provides credit to factoring companies and directly (especially under reverse factoring schemes), organises learning and skill-building workshops, and offers legal and regulatory advice/consulting services and technical assistance to promote

good practices in Africa. In line with the aspirations of the free trade agreement regarding intra-African trade and also to integrate African SMEs into global value chains, factoring is imperative to close the trade financing gap.

Factoring enables SMEs to finance customer receivables and provides guarantees against unpaid invoices while securing the cash flow of the company. Moreover, factoring accompanies SMEs throughout the business cycle, allowing them to be financially supported at each phase of their development:

- at the inception phase, by lightening the burden and structuring the development of the company to benefit from financing;
- in the growth phase, by making it possible to inject liquidity, since factoring proves to be a cash accelerator;
- during difficult periods, by securing financing based on the quality of the customer base and billing.

The global factoring industry is flourishing, albeit at a suboptimal level of performance characterised by uneven concentration in different markets (IFG, 2013; 2014). Although still an insignificant player in the global factoring market, Africa has made great strides in the past decade with an average annual growth of 14.2%, from €5.86 billion in 2001 to €23.93 billion in 2012, exceeding the global industry average growth rate of 8.6% (Oramah, 2013). In the current era of the COVID-19 pandemic, Mulroy (2020) predicts a significant rebound in 2021 and beyond as banks pull back credit facilities.

Several measures are required to harness the potential of factoring in Africa. Satta (2006) advocated for a conducive legal and regulatory environment, a strengthened credit information infrastructure, a favourable tax regime and growth in factoring associations. Timmermanns (2009) advocated for increased awareness and recognition of factoring, harmonisation of the legal and regulatory environment, knowledge sharing, best practices and information, and support to the establishment of factoring activities in new markets.

4. Implications for intra-African trade

As Africa moves toward greater economic integration in the context of the free trade agreement, it is important to address major obstacles to intra-regional trade, including financing, to fully maximise the benefits of regional integration. The free trade agreement seeks to de-fragment Africa and boost the continent’s competitiveness and cross-border trade. Ultimately, removal of duties on 97% of tariff lines is expected to boost intra-African Trade by 52.3% by 2022 and to more than double within the first decade. This is especially likely if implementation of the agreement is accompanied by robust trade facilitation measures, including tariff removal. If complemented by policies targeting non-tariff barriers, while improving trade logistics, and addressing poor infrastructure and deficit of trade finance, trade facilitation can be four times more effective in stimulating trade (Tajudeen, 2019).

While trade integration has the potential to boost productivity and growth and contribute to structural transformation in African economies, SMEs need access to trade finance on a sustainable basis to support their growth and expansion. In a continent where trade finance gaps remain a challenge and SMEs are the hardest hit, factoring has the potential to contribute to transforming SMEs into large companies while significantly expanding cross-border trade. Accordingly, factoring will provide the financing solution as the pivot around which a significant traction would be gained on intra-African trade promotion, as well as extra-African trade, under the free trade agreement.

To reiterate, sales on open account are expected to increase in the context of intra-African trade. With the support of FCI and other partners, banks and non-bank financial institutions interested in factoring are emerging across the continent. To address the risk issues associated with open account trade, these financial institutions can access FCI's two-factor system and correspondent factoring network in the quadrant arrangement discussed above. An importer in an African country can easily transact business with an exporter in another African country. The exporter assigns the receivables due on the sale to the export factor and then to the import factor. The export factor provides finance and receivables ledger management while the import factor provides collection services and remittance of funds to the export factor.

5.Conclusion

This paper introduced factoring as an important financing instrument in support of SME operations and development, to position the sector as a significant contributor to the promotion of intra-African trade, industrialisation and structural transformation of African economies during the implementation of the AfCFTA. Although there has been significant development in factoring around the continent, much more needs to be done, particularly in the policy, legal and regulatory space. More awareness of factoring as an alternative financing tool in support of SMEs is needed because SMEs disproportionally suffer exclusion from the services of traditional financiers. Significantly, factoring also has the potential to stimulate other financial services, especially credit insurance, that will permit de-risking of SME-related transactions.

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