INTRODUCTION

Access to trade finance remains a significant challenge for African firms. Recent estimates from the AfDB and Afreximbank (2020) shows that the estimated value of unmet demand for trade finance in Africa was US$ 81.80 billion in 2019 and has averaged USD 91 billion over the past decade. Indeed, this is reflected by the low percentage (40%) of African trade that is bank intermediated compared to 80% globally.

DECLINE OF CORRESPONDENT BANKING IN AFRICA

Many factors contribute to the large trade finance gap in Africa. Challenges with confirming banks is one of the major constraints for domestic banks engaged in trade finance in Africa. SWIFT data analysis shows that globally 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 between 2011 and 2017. Africa saw a decline of 18.6% compared to an average of 17.9% for all regions over the same period (Financial Stability Board, 2018). Not surprising, in Africa about 21% of private owned and 19% for public owned banks list challenges in building correspondent banking relationship as a major constraint to their trade finance activities, relative to 17% of foreign banks. Over the past decade, the top correspondent banks in Africa saw significant decline in their trade finance confirmation activities in Africa.

Figure 1 shows the percentage of issuing banks in a survey that report having confirmation relationships with the top 10 global corresponding banks in Africa. Among the top 5 banks, all but Citibank registered a decline in correspondent relationship between 2011 and 2019. For instance, in 2012 Standard Chartered Bank had 9% of African Banks confirmation relations compared to 5% in 2019, while the Dutch Bank’s relations decreased from 7% in 2012 to 4% in 2019.
3 | DRIVERS OF DECLINING CORRESPONDENT BANKING RELATIONSHIPS

Recent studies have shed light on the reasons for declining correspondent banking relationships in Africa. A survey by the World Bank (2018) finds that low profitability due to increased compliance cost, declining risk appetite and high cost of customer due diligence are the top three reasons for declining corresponding banking relationships globally. These findings are consistent with recent AfDB-Afreximbank (2020) survey of trade finance activities of banks in Africa. African banks identify regulatory restrictions as one of the main factors that constraint trade finance on the continent. Most correspondent banks find the risk weighted capital requirements for trade finance transactions too high and have either scaled back their trade finance activities or exited the African market. In addition, anti-money laundering regulations have increased due diligence and know-your-customer compliance costs and have made small transactions less profitable for global banks.

4 | IMPACT OF DECLINING CORRESPONDENT BANKING RELATIONSHIPS ON TRADE FINANCE IN AFRICA

Declining correspondent relationship decreases competition, raises transaction costs, and leads to more fragile networks since failure of a participant could have larger effects on the trade finance market in a single economy (FSB, 2018). Second, it could exacerbate already unequal access to trade finance services across the region, especially as global banks exit risker segments of the market in Africa, including in fragile economies in Central Africa and North Afri-
The advent of COVID-19 had a devastating impact on African economies, and more so on trade finance activities. It led to tightening of global financial conditions which triggered massive capital outflows from Africa, exceeding $5 billion in the first quarter of 2020 (Afreximbank, MFW4A, UNECA and AfDB, 2020). This exacerbated liquidity constraints and continues to undermine the capacity of banks to finance African trade especially for SMEs (Eugene Bempong Nyantakyi, E B and Drammeh, L M.2020). The liquidity constraints led to the number of correspondent banking relationships falling across the region and increased rejection of letters of credits. For example, about 38% of local/privately-owned banks and 30% of foreign-owned banks reported an increase in rejection rates during the first quarter of 2020 (Afreximbank, et al., 2020). The increased rejection of letters of credits and the decline in correspondent banking relationships is expected to continue as the COVID-19 pandemic continues to devastate the continent’s economies and thus increasing the trade finance gap on the continent. In 2019, the trade finance gap in Africa was estimated at USD 82 billion (AfDB-Afrixembank, 2020). Trade finance activities in general are facing challenges not only in the region but also in other regions of the world. For example, in the OECD countries, COVID-19 has led to increased costs of financing for SMEs trade finance activities and higher rates of rejected applications for letters of credits (OECD, 2021).

FIGURE 2 DISTRIBUTION OF CORRESPONDENT RELATIONSHIPS BY SUB-REGION AND YEAR IN AFRICA

[Bar chart showing distribution of correspondent relationships by sub-region and year in Africa.]


5 IMPACT OF THE COVID-19 PANDEMIC ON AFRICA’S TRADE FINANCE ACTIVITIES

The advent of COVID-19 had a devastating impact on African economies, and more so on trade finance activities. It led to tightening of global financial conditions which triggered massive capital outflows from Africa, exceeding $5 billion in the first quarter of 2020 (Afreximbank, MFW4A, UNECA and AfDB, 2020). This exacerbated liquidity constraints and continues to undermine the capacity of banks to finance African trade especially for SMEs (Eugene Bempong Nyantakyi, E B and Drammeh, L M.2020). The liquidity constraints led to the number of correspondent banking relationships falling across the region and increased rejection of letters of credits. For example, about 38% of local/privately-owned banks and 30% of foreign-owned banks reported an increase in rejection rates during the first quarter of 2020 (Afreximbank, et al., 2020). The increased rejection of letters of credits and the decline in correspondent banking relationships is expected to continue as the COVID-19 pandemic continues to devastate the continent’s economies and thus increasing the trade finance gap on the continent. In 2019, the trade finance gap in Africa was estimated at USD 82 billion (AfDB-Afrixembank, 2020). Trade finance activities in general are facing challenges not only in the region but also in other regions of the world. For example, in the OECD countries, COVID-19 has led to increased costs of financing for SMEs trade finance activities and higher rates of rejected applications for letters of credits (OECD, 2021).
6 | POLICY RECOMMENDATIONS

Measures to help build stronger correspondent banking relationship are critical for improving access to trade finance for enterprises in Africa. Some of these measures are:

Provide risk mitigation instruments to facilitate trade finance transactions in Africa. Risk participation agreements (RPA) and transaction guarantee facilities with global issuing banks that help to de-risk trade finance transactions can play a role in expanding confirming banking relations in Africa. The good news is that many development finance institutions such as the African Development Bank and IFC have RPA and transaction guarantee agreements to help support trade in Africa. Efforts should be made to expand DFI risk participation agreement facilities to non-traditional confirming banks in emerging markets that are stepping in to fill the gap as more established global correspondent banks continue to retreat from the continent.

Reassess the high level of capital requirements against trade finance transactions. Given the relatively low-risk profile of trade finance transactions globally, regulators could reassess the high level of capital requirements against trade finance transactions that have contributed to the attrition of global correspondent banks in Africa. Letters of credit, the most common trade finance instrument, are usually low risk and short-term in nature. The most recent ICC Trade Register data confirms that trade finance default rates from 2008-2018 are low across all products and regions surveyed and averaged about 0.37% for Import Letters of Credit (L/Cs), and 0.05% for Export L/Cs. (ICC, 2021).

REFERENCES


