THE EFFECT OF GLOBAL AND REGIONAL ISSUES ON AFRICAN TRADE FINANCE

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Who would have thought that nearly a decade after the financial crisis of 2007/2008, the global financial services industry would still be feeling the effects? Global trade and capital flows are yet to recover to pre-2008 levels and many believe that this is unlikely to happen in the short to medium term. At a time when the leader of the world's largest economy is attempting to scale back the very globalisation that has helped international finance to prosper, this is a worrying trend.

The main focus of this article is the effect on the financing of trade in Africa of certain global, macroeconomic and regional issues. In addition to looking at causal effects, this article will also address what the future may hold, and what those operating in Africa can do to adapt to what many consider to be the "new normal" for trade finance.

The period since the start of the 2007/2008 financial crisis has seen regulators requiring banks to take a far more robust and conservative approach to risk, both in terms of increased capital requirements and enhanced due diligence/compliance. The net effect of this change is that the cost of doing business in emerging markets in particular, has significantly increased at a time when banks need returns to increase in order to balance the effects of increased capital requirements and transactional costs.

This is not the only issue facing the banks though. General trade volumes have fallen. According to a recent report by the management consulting firm McKinsey, there has been a 65 per cent fall in gross cross-border capital flows since 2007 with $4.3 trillion dollars flowing across the globe in 2016, compared with $12.4 trillion in 2007. There is simply less trade to finance and this is equally true in Africa where trade figures are also much reduced.

There is an element of chicken and egg here – would there be more trade if there was more finance available – but this is not the only factor contributing to the drop in trade finance. If we look at Africa, whilst there are a few large syndicated deals, much of the trade that requires finance is being carried out by second tier players and by the SME market. It is exactly these types of entities that are proving more difficult and costly for banks to finance from a due diligence/compliance/capital requirements perspective than previously, with the result that many of these deals do not get financed despite otherwise being "good deals".

As noted above, the increased regulation and compliance issues affecting banks operating in the trade finance market is not the only driver for the fall in trade finance levels. The global fall in commodity prices has also taken its toll. Most notably, the price of a barrel of oil is at present around a third of the value at its 2008 peak. The price reduction can be explained in part by the 'shale revolution' in the United States and in part by reduced demand from China as it rebalances its economy away from manufacturing and towards consumption. In addition, Saudi Arabia has arguably kept production at steady levels (therefore ignoring reduced demand) to retain market share and outflank its resurgent rival Iran.

In terms of other commodities (most notably copper and iron ore), falling prices have been felt most severely in Africa. Whilst it is certainly possible to finance commodities at low prices (think of the Russian oil financings of the late 1990s when oil was at $14 per barrel or even lower) and it can provide borrowers with an opportunity for cheaper credit, the margins become that much thinner for both banks and borrowers.

At a time when bank returns need to increase to offset additional regulatory costs, the low prices erode yield, put pressure on borrower cashflows and make many deals uneconomic. This has led to various African economies once touted as examples of economic growth, facing severe economic problems due to reduced revenues and insufficient liquidity from the banking market. Growth has stagnated, for example, in Angola, Kenya, Nigeria and Sierra Leone.

As well as a lack of liquidity in the global financial markets generally, Africa faces other more regional issues. First of all, there is still a perception, particularly amongst those less familiar with operating on the continent, that Africa is a riskier place to do business in comparison with other emerging markets. Whilst the reality is somewhat different, the situation is not helped by individual overt examples of instability and corruption.

Nigeria has faced an Islamist insurgency from the Boko Haram group since 2009 in the country's north-eastern Borno State. The insurgency has affected the oil producing regions to an extent, but it is also seen as a destabilising factor.

The same is true for the Democratic Republic of Congo (DRC), where intermittent violence is a disruptive influence. If President Kabila does not step down from power before the end of 2017 (as he has promised) renewed violence is highly likely.

In Kenya, the result of the recent Presidential election has been rescinded with a re-run scheduled for 26 October.

Commentators are concerned about potential civil unrest depending on the result of the re-run. These are the types of issues which cause lenders (or more particularly their credit committees) and companies with substantial interests in the continent to consider the potential downside of doing business on the continent.

Considering the size of the continent, the level of instability overall is no greater than elsewhere in the emerging markets and actually far less in most African jurisdictions. There is however an inability to dispel the perception which many still hold.

Second, according to the McKinsey report referenced above there has been a noticeable decline since 2011 in correspondent banking relationships globally.

For banks involved in trade finance in African countries where they do not have a physical presence, this trend certainly applies to a greater extent than in other emerging markets. The trend could be explained by increased regulatory requirements (such as money laundering, sanctions, know your customer (KYC) etc) to which international lenders are subject. The requirements on their correspondent banks on the continent are not necessarily at the same level and this obviously leaves lenders with potential regulatory and reputational risks. For some of the international banks, this is simply a risk not worth taking and without these correspondent institutions it becomes increasingly difficult for them to do business where they are not on the ground. This seems to be the position disproportionally in Africa and has resulted in a significant gap in funding options.

Third, the perception of corruption still exists. Again, whilst the position has improved significantly in recent years and the number of instances causing concern is relatively small in the context of the volume of business done on the continent, there are still some examples which feed the perception that Africa has more problems than other emerging markets. A case in point is the ongoing investigation of a former oil minister and several large Western multinationals in Nigeria in relation to payments made in exchange for oil contracts. These high profile cases give a distorted view of the continent and seem to cause more consternation amongst international banks than equivalent issues elsewhere.

In terms of the future for Africa, it doesn't look like the issues discussed above are likely to change any time soon. So how can Africa overcome the difficulties it faces? In order to make a real difference, there should be two main objectives – increase sources of funding and seek better yields through increasing the value of what is produced. As regards the latter point, countries that produce large amounts of commodities such as the DRC, Cote D'Ivoire and South Africa are still only extractors. They do not possess the infrastructure to turn commodities into consumer products or products higher up the value chain which would provide them with enhanced cashflows and put them in a more advantageous position when seeking finance.

As regards seeking out additional sources of funding, in an environment of low prices, it is likely that new players will move into the market. This is particularly relevant for non-bank financial institutions such as investment funds. They are well placed to plug the funding gap and in particular the SME market. They don't have all of the same issues that bank funders have, in particular the capital requirements and the risk of significant fines from the regulator in the USA. In many instances, they can also move more quickly and provide more bespoke structures than the banks on lower value deals. Chinese lenders with large foreign reserves are also able to step in to replace the lost funding from the international banks, though it remains to be seen whether African borrowers would welcome such a move if they have the choice.

Looking forward, a rise in commodity prices would help but this is based on a number of factors falling into line which are difficult to predict, though an increase in demand from China amongst others is likely to be critical to this – this is quite timely as it comes at a pivotal time as the Chinese Communist Party convenes for its 19th National Congress in October. On a macroeconomic level, threats and rhetoric from North Korea present challenges as does the unpredictability of the current US administration. This looks an unlikely source of comfort at least in the short term.

The paradox to understand is that although many African economies continue to grow, global financial conditions and systemic risk present challenging conditions for both lenders and borrowers in Africa. As ever, the risks in Africa tend to be overplayed and perhaps attempting to educate those less familiar with the continent (and those credit committees that should be familiar with it) is one way forward. Either way, improving the position is likely to be a steady rather than a transforming process.

Contributor's Profile

Simon Cook is a partner in the Trade & Export Finance Group in law firm Sullivan & Worcester's London office. He has experience in a wide variety of banking and finance transactions, including structured trade finance, trade finance, commodity finance, project finance, invoice discounting facilities, warehouse finance, supply chain finance, ECA finance and borrowing-base facilities. He advises on transactions across Africa, the Middle East, Asia and the CIS. His work covers a range of financings acting for both lenders (including multilateral agencies, development finance institutions and investment funds, as well as commercial lenders) and borrowers notably in the oil, telecoms, soft commodities and metals sectors in Africa and the Middle East, where he was based for four years. Simon also acts for industry bodies such as the International Trade and Forfaiting Association (ITFA).

Simon has recently authored a chapter on Trade Finance in Globe Law and Business' new book entitled Oil and Gas Trading and chapters for Sweet & Maxwell's book entitled A Practitioner's Guide to Trade and Commodity Finance. In Chambers UK, 2017 Simon is a Ranked Lawyer for Commodities: Trade Finance and in the UK Legal 500, 2016 he is recognised as a Leading Individual.