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# Contemporary Issues in African Trade and Trade Finance

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# CONTEMPORARY ISSUES IN AFRICAN TRADE AND TRADE FINANCE (CIAT)



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**HEAD OFFICE**
African Export-Import Bank 72(B)
El Maahad El Eshteraky Street
Heliopolis, Cairo 11341
P O Box 613 Heliopolis
Cairo 11757, Egypt
Tel: +202 24564100/1/2/3
Email. info@afreximbank.com
Website: www.afreximbank.com



The *Contemporary Issues in African Trade and Trade Finance (CIAT)* is introduced by the Bank to provide a platform for the staff of Afreximbank and other individuals knowledgeable in African trade and trade finance to publish articles in the areas of trade, trade finance and economic development in Africa. The CIAT publishes technical and non-technical papers. Edited by a Committee, drawn from both internal and external sources, it also publishes relevant papers presented at conferences or seminars and those presented at the Bank's internally organized Knowledge Sharing Sessions. The journal welcomes editorial comments and responses which will be considered for publication to the extent that space permits.

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# CONTEMPORARY ISSUES IN AFRICAN TRADE AND TRADE FINANCE (CIAT)

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# FOREWORD

Stringent regulatory regimes, especially in major money centers have substantially raised compliance costs for internationally active banks. In developing economies with small fragmented markets and where the marginal costs of compliance are seen as disproportionately higher than marginal revenues, most global financial institutions, with weakened absorption capacity in the post-crisis environment, have opted for de-risking—essentially exiting relationships and closing the accounts of clients based in countries considered "high risk".

In this global environment of decreasing risk appetite, which has characterized the transition from the old rule-based towards risk-based systems, Africa has become a victim. In addition to increasing costs of financial services to African entities, a large number of multinational banks have withdrawn from correspondent banking relationships with wide-ranging consequences for trade finance and economic growth in the region.

For the continent as a whole, the inherent costs associated with the adoption and rollout of de-risking strategies were magnified by a number of factors. First, the rather unexpected timing of large-scale withdrawals of international banks from the African financial landscape made it difficult for countries to adjust and evolve towards new mechanisms and solutions. Second, the costs associated with the unexpected withdrawal were further exacerbated by the structure of the African financial system which is still largely dominated by foreign banks and financial institutions.

Volume 3 Issue 1 of Contemporary Issues in African Trade and Trade Finance (CIAT), looks at the challenges of promoting African trade and investment in a difficult global and financial environment where an increasingly stringent regulatory environment has decreased the willingness and capacity of global financial institutions to absorb risk. It brings together articles assessing the potential implications of rising costs of compliance and globalization of corporate governance for African economies and financial institutions, papers exploring alternative sources of financing available to corporate entities within the region, and those examining the legal requirements for regional trade agreements as African governments pursue the Continental Free Trade Area (CFTA).

After a review of the rising costs of compliance and the potential implications of the changing regulatory framework for African banks and financial institutions, the first paper outlines a set of interventions carried out by the African Export-Import Bank to manage the challenging African and global economic and financial environment with a view to enhancing a smooth integration of African corporate and financial institutions into a world of increasingly globalized finance.

The second paper reviews the ongoing process of globalization of corporate governance and assesses the potential implications of corporate governance standards for capital accumulation and growth. It suggests that despite the ongoing trend towards globalization, corporate governance is still highly correlated with the stage of development, explaining the coexistence of several forms of corporate governance in most countries.

The third and fourth papers focus on two innovative financing options for promoting trade and growth of small and medium-sized enterprises in Africa—factoring and supply chain finance. After reflecting on the merits of factoring as a financing alternative for SMEs the third paper outlines a framework for promoting factoring in the region. The fourth paper shows that the use of supply chain finance which has several benefits for African corporates is still very limited in Africa, owing in part to the low rate of technology adoption, the knowledge gap in supply chain finance, and a deficit of infrastructure.

The last paper which focuses on regional trade agreements in Africa, reviews the architecture of various Regional Economic Communities (RECs) against existing WTO rules. It argues that the rationalization of Free Trade Areas envisaged within the context of the establishment of the Continental Free Trade Area (CFTA) should be consistent with requirements of international trade rules.

I had the opportunity to peruse the different articles published under the current Issue of CIAT and would like to recommend them to readers. The articles are very topical and will introduce the readers to various options contemplated by African corporates, financial institutions, and governments to promote African trade and economic growth in a challenging global economic and financial environment.

**Dr. Benedict O. Oramah**
President and Chairman of the Board of Directors
The African Export-Import Bank

# Contemporary Issues in African Trade and Trade Finance

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# CHANGING REGULATORY FRAMEWORKS, RISING COSTS OF COMPLIANCE AND IMPLICATIONS FOR FINANCIAL INSTITUTIONS IN AFRICA[1]

Benedict O. Oramah*

**Abstract:** Complying with emerging regulations and the changing global compliance environment has become one of the key operational challenges for banks and financial institutions in developed and developing countries alike. Most banks have responded by raising the level of resources allocated to compliance with new regulatory standards, but others, especially large multinational banks, have opted for de-risking, essentially scaling down their operations in jurisdictions they consider highly risky. This paper reviews the costs of such compliance and assesses their implications for African banks and financial institutions while pointing out Afreximbank's interventions towards managing the emerging challenges.

**Keywords:** Africa, compliance, banks, financial institutions, regulations

## 1. Introduction

The 2008/9 global financial and economic crises triggered by the United States (US) sub-prime crisis underscored the huge size of the threat that a fragile financial sector poses to the global economy in a context of a dynamic and increasingly integrated markets. Risks of global terrorism have also risen considerably especially since Al-Qaeda and ISIS internationalised their activities. In response to the crisis and threats, governments and regulatory agencies

1 This paper is an extension of the keynote address delivered by President Oramah during the Customer Due Diligence and Corporate Governance Forum organized by the African Export-Import Bank in Seychelles in October 2015.

* President and Chairman of the Board of Directors, The African Export-Import Bank

adopted measures aimed at strengthening banks and financial institutions and promoting financial stability and soundness and emphasising sound customer due diligence at the global level. Among the key measures that have come to the fore are an increasingly stringent compliance environment and the globalization of corporate governance.

Beyond adjusting to this shift towards uniform application of corporate governance standards across multiple jurisdictions, financial institutions face a more volatile and costly compliance environment of enhanced customer due diligence. Enforcement of sanction regimes across borders acts as a deterrent to international activities of globally active banks, leading such banks to de-risk by scaling down their operations in jurisdictions they regard as highly risky. They see Marginal Cost (MC) of compliance far higher than Marginal Revenues (MR) of operating in small, fragmented markets.

Why should these developments be of interest to African sovereign and corporate entities, as well as development finance institutions, and what are the implications for Africa's financial services sector and economic development aspirations? This paper seeks to address these questions and shed some light on their implications for financial institutions in Africa where correspondent banking services have been withdrawn, scaled down in most countries, or are still provided by global banks but at a much higher cost.

## 2. The Changing Regulatory Environment

In the decade since the 2008/09 global financial crisis, a large volume of research has been conducted to uncover its causes. Overwhelmingly, the research points to weaknesses in the financial industry, including over-leverage, sup-optimal volumes of high-quality capital and liquidity, compliance failures and inadequate risk evaluation and assessment. In addition, the high degree of interconnectedness among financial institutions accelerated the propagation of risks and shocks from the epicentre—the US—resulting in massive costs for the global economy. According to the Basel Committee on Banking Supervision, which defines global standards for banks, the crisis cost more than US$76 trillion in lost output for its member countries. Specifically within the banking sector of the European Union (EU), the International Monetary Fund estimates that crisis-related losses incurred by European banks between 2007 and 2010 amounted to almost €1 trillion, 8 percent of the bloc's gross domestic product. The crisis dramatically exposed the global financial markets' pro-cyclical capital framework—one that amplifies adverse (or positive) shocks in an economy. It also highlighted a lack of early-warning signs and reliable indicators of financial sector vulnerabilities. Shortcomings in prudential standards for banks were laid bare in 2008, suggesting that many banks were not following robust risk management strategies and lacked the financial capacity to absorb big losses triggered by poor supervision. The Basel Committee on Banking Supervision has since been at the forefront of reforms to strengthen banks' regulation, supervision and risk management in the transition to Basel III.

Globally, Basel III seeks to improve the assessment of risk within financial markets, including the quality and quantity of bank capital, restrictions on leverage, off-balance sheet exposure and counterparty exposure. Some of the reforms target the negative impact of pro-cyclicality by including elements such as a counter-cyclical capital buffer, a capital surcharge for global systemically important banks, and a principles-based framework for their domestic counterparts (BIS 2011). Basel III builds on Basel II, which itself underscored the need for a strong financial sector—including capital adequacy, risk-based banking supervision and discipline as important catalysts for economic development—requiring a greater volume of highly liquid assets and of long-dated and stable wholesale funding to minimize funding volatility in times of stress (Thieffry 2011).

Basel III reiterates the need to enforce cooperation of monetary, fiscal and supervisory authorities around the world and to enhance supervision and corporate governance across jurisdictions.[2] In a related vein, the European Central Bank (ECB 2017) argues that complex rules are needed to supervise complex internal bank operations; that strong rules foster trust; that well-

2 The extent of changes to the regulatory environment around the globe since 2008/9 revolving around Basel III was pithily summarized by Andrew Haldane (2011), who described Basel I as having seven risk categories requiring seven calculations, and Basel II/III more than 200,000 categories requiring more than 200 million calculations.

capitalized banks are better prepared to withstand shocks; and that if banks keep credit flowing to the economy even in tough times, economic growth becomes more sustainable.

Still, the introduction of the Basel Accords has further layered the financial market regulatory landscape, which has undergone huge changes over the last decade, raising the requirements of regulatory compliance. Data suggest that at the global level financial regulators issued 51,500 regulatory alerts in 2015, a 27 percent increase from 2014, and far higher than the 8,700 alerts issued in 2008 (Thomson Reuters 2017). Increasingly, the question arises: Does the plethora of regulations create a relative disadvantage for banks, especially by raising cost structures?

## 3. The Emerging Costs of Regulatory Compliance and Implications for Trade Finance

Industry analysts predict that if Basel III is fully implemented it could lead to a reduction in global trade finance capacity and increase prices by as much as 40 percent (Basel Committee 2011). As institutions prepare to meet the new liquidity requirements by shifting into more liquid assets (such as cash and central bank deposits) there could be an adverse impact on the real economy.

Beyond the general issue of the macroeconomic environment and the risk of other shocks, a key concern is the effect of tighter regulation on the availability and cost of financing. Ensuring sufficient governance, expertise, controls and coordination poses heavy operational challenges for financial market players. A 2014 KPMG survey suggests that compliance with the Dodd Frank Act cost the top eight US banks US$34 billion annually. This is corroborated by the Boston Consulting Group, which indicates that globally between 2008 and 2016 banks paid US$321 billion in fines relating to regulatory failings ranging from money laundering to market manipulation and terrorist financing. Existing evidence suggests that every global, systemically important bank has been fined in recent years (Bloomberg (2017). Although none of these fines has been levied for deals involving African countries, international banks are increasingly unwilling to expose themselves to such risks, especially in so-called high-risk jurisdictions that contribute very little to their overall revenues.

But the cost of compliance is not simply the amount handed over in fines, but also the cost of ending a business line, curtailing the provision of certain services, or damaging the reputation of a brand. Further, data quality and reporting now form a key pillar for financial institutions looking to comply with evolving regulations. Within the compliance ecosystem, the availability of reliable data on clients and processes, for internal use and for reporting purposes, is a huge challenge, though it could go a long way towards reducing compliance risks and costs.

To ensure accountability for data quality at the top of large, complex organizations, chief financial officers in some jurisdictions are now required to attest to the accuracy of their reports for capital assessments and stress testing. These data need to be traceable and integrated with a consistent enterprise-wide form so it can be used without requiring an understanding of individual source systems' peculiarities. To the extent that poor and unreliable data directly raise the personal liability risk of senior compliance officers and managers, it is in their best interest to implement more robust systems and procedures. These measures are also embedded within Basel regulations relating to effective risk data aggregation and reporting. Another key challenge for firms to mitigate compliance risk is the cost of undertaking more with less, which will require heavy investment in people, processes and data.

That said, according to regulators, the long-term economic benefits far outweigh the costs. In the EU for instance, regulators argue that while there will be a marginal decrease of 1.8 percent in the stock of loans in 2020–30 and an average increase of only 0.29 percentage points in loan rates for that period, the net economic benefits will be an increase of 0.3–2 percent in EU gross domestic product, stemming from a reduction in the expected frequency of systemic banking crises (KPMG 2014). Regulators expect a reduction in the probability of such crises within a range of 29–89 percent when banks recapitalize to a total capital ratio—including buffers—of at least 10.5 percent (Commission Services, Basel 2011).

The increasingly stringent regulatory environment has specific implications for trade and structured trade finance. For Basel II, commodity finance is described as *"Structured short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities (e.g. crude oil, metals, or crops), where the exposure will be repaid from the proceeds of the sale of the underlying commodity and the borrower has no independent capacity to repay the exposure".* This is the case when the borrower has no other activities and no other material assets on its balance sheet. The structured nature of the financing is designed to compensate for the weak credit quality of the borrower. The exposure's rating reflects its self-liquidating nature and the lender's skill in structuring the transaction rather than the credit quality of the borrower.

Despite the low-risk and highly collateralized nature of trade finance assets, such as letters of credit and other self-liquidating commitments, many bankers and commodity traders are apprehensive that tighter regulation of banks and financial institutions more generally will make it increasingly difficult for potential suppliers to deliver, at competitive cost, trade finance to the companies that depend on it—in a continent where unmet demand for trade finance is already estimated at over US$120 billion annually. The strictures are being felt keenly in the oil and gas industry, especially in upstream exploration and production, given lower hydrocarbon prices.

The oil and gas sector is crucial for Africa, with oil-exporting countries contributing about 55 percent of the region's output and oil receipts accounting for over half the continent's export revenue. The end of the commodity super-cycle, moderately tighter financing conditions and some lenders' waning risk appetite have now, with tighter regulations, substantially increased the cost of credit extension in the industry, causing missed opportunities for aggregate output expansion and trade—extra- and intra-African.

The challenge for trade services is also aptly demonstrated from the strict regulations to bank capital under Basel II (and even more so under Basel III), which require banks to hold a greater volume of high-quality capital against more conservatively calculated risk-weighted assets. For instance, using the standardized approach to calculating capital requirements for credit risk, a loan to a corporate commodity trader with a credit assessment of below BB- will attract a risk weight of 150 percent and a capital requirement of 12 percent, while a loan to an AAA-rated corporate client will be risk-weighted at 20 percent (RSRB 2007). This novel approach to credit risk makes it unlikely that banks operating the standardized approach will lend competitively to (generally small and medium-sized) African firms. Alternative approaches that take into account the volatility of assets and earnings are also likely to result in African borrowers having a hypothetically high probability of a default rating, making them susceptible to penalties under Basel regulations.

## 4. Implication for African Financial Institutions

In a world where recurrent financial crises, global recessions and financial malpractices have been among the main contributors to the demise of global financial giants, including Lehman Brothers and Bear Stearns, the strengthening of banking supervision guidelines and compliance reforms—largely encapsulated in Basel III—has become an imperative for financial institutions around the world, including Africa. Nonetheless, compliance with Basel III has raised concerns for the African financial industry. The African Development Bank, for example, has described Basel III's prescriptions as costly "one-size-fits-all" reforms that may not be compatible with all Africa's countries (AfDB 2012).

Broadly, the changing regulatory environment and associated compliance measures are largely perceived in most parts of the continent as potential sources of significant increase in the cost of capital. Compliance with Basel III also means that all financial institutions, including those in Africa, are required to maintain higher capital buffers and strictly conform with the minimum acceptable level of fundamental financial ratios. For instance, while under Basel II, Tier 1 capital was set at 4 percent, under Basel III, banks are required to hold 6 percent (Van Dyk 2010). And beyond meeting the minimum capital requirement ratios, all banks must also hold a capital buffer in excess of the minimum 8 percent of total capital under Basel III (Van Dyk 2010). These requirements generate sizeable knock-on effects on national economies as they exert tremendous pressure on credit availability in a region where access to credit is already too low to sustain economic growth (EIB 2016).

Although some countries in the region, such as South Africa and Tunisia, have chosen to fully align their banking sectors with Basel III, many others, including Kenya and Nigeria, have opted to proceed more cautiously as they apply only parts of the provisions that appear more relevant to support their economic growth and national development priorities.[3] Some of the African financial institutions' difficulties with the new compliance regime are because these reforms have been designed to support large financial institutions in advanced economies with a deep or mature financial sector. Most of these institutions are involved in multi-dimensional operations, including those beyond their nations' boundaries, and have a robust, long-term asset-based portfolio. The financial sector in Africa, however, remains weak and dominated by relatively basic lending activities.

African correspondent banks are also increasingly anxious, given the new compliance risks and that some large international banks and investors are unwilling to expose themselves to such risks, especially in Africa, which they regard as high risk (Erbenová et al. 2016). This perception undercuts the business relationships between international and African correspondent banks, and weakens the lending capability of these correspondent banks—limiting their operations and exacerbating the scarcity of trade finance.

3 Even South Africa, which has Africa's deepest and most integrated financial sector, may not avoid adverse effects. Reports have underscored the risk of insufficient financing to support some of its social programmes.

Still, the changing regulatory environment potentially has benefits for Africa's financial industry and the economy as a whole, because African financial institutions may be compelled to adjust their systems to accommodate the new compliance norms, which now constitute the benchmark for best practices, and so improve their reputation, enhance their competitiveness and more tightly integrate with the rest of the world's financial industry. As these institutions upgrade, they are set to minimize their exposure to malpractice and avoid financial sanctions. They are aided by, for example, the Inter-Governmental Action Group against Money Laundering in West Africa, which supports those in the sub-region establishing structures to strengthen their capacity to combat activities related to financial crimes such as money laundering and terrorist financing. In South Africa, the Financial Intelligence Centre has outlined the legal frameworks for these actions.

Reinforcing due diligence and "Know Your Customer" principles across the continent, fostering strict application of anti-money laundering and terrorist financing policies (among other financial crimes)—while deepening the culture of good corporate governance—has other benefits, notably for investment and economic growth. Africa has often been regarded as the new frontier for investment, attracting foreign investors and forging correspondent banking relationships with international banks—all vital factors for the strong growth (now slipping) of the last decade or so. Efforts by African sovereign and corporate entities to reduce compliance risks and more generally high risk perceptions could help sustain investment against a backdrop of contracting global demand.

As part of a cocktail of risk-mitigation measures, firms can overcome the challenges of regulatory change by investing in the right management, analytics and technology, which will enable them to view the capital and constraints created by the new compliance measures. Recent advances in digitizing data are helping to lower the overall cost of business. Bloomberg reported in March 2017 that the Royal Bank of Scotland Group is preparing to eliminate as many as 2,000 jobs related to checking new customers for suspicious traits as it digitizes the process. Similarly, HSBC Holdings expects spending on regulatory programmes and compliance to peak at about US$3.3 billion in 2017, after surging in recent years, as improved information technology systems help the bank to grow without adding to personnel costs.

A development finance bank with a strong mandate to promote extra- and intra-African trade, Afreximbank continues to work to ensure that the continent has the right risk governance and approval framework for businesses to comply with regulatory standards and to enable it to conduct operations with its clients. This will help in promoting optimal business risk thresholds and product selections.

As a way of reducing operational costs linked to compliance and the cost of trade finance for African entities, Afreximbank has launched the African Customer Due Diligence Repository Platform. This platform aims to provide a centralized single source of primary data required to conduct compliance and due diligence checks on African counterparties, reducing their costs of compliance and thus of trade finance—and therefore increasing the availability of trade finance. Additionally, the expansion of the African Correspondent Banking network will deliver a co-branded product targeted at expanding access of African banks to efficient, reliable and flexible correspondent banking services that are tailored to banks' individual needs and that leverage long-term relationships that Afreximbank has built with potential beneficiary banks over the years.

Afreximbank is also investing to increase awareness about an increasingly stringent regulatory environment and to reduce compliance risks across the continent, working closely with other African financial institutions. In particular, the Annual Customer Due Diligence and Corporate Governance Forum, which it launched in 2014, has been a timely contribution. The forum's vision is to become a leading global conference that brings together experts from African financial institutions, other firms as well as regulators, in order to share international best practices and to network with African peers.

## 5. Summary and Conclusions

Due to the changing global landscape of financial services regulation, reducing compliance risk and promoting good governance, compliance and corporate governance have emerged as critical interventions to promote stability and soundness in the financial services sector. The application of sweeping and evolving changes to regulatory requirements in many jurisdictions has been accompanied by complexities within the industry and challenges for banking sector participants. In a region such as Africa, where bridging the trade finance gap remains daunting, the overall effect has been the ever-increasing cost of compliance and the reduction of lending to business, especially trade finance.

In the short to medium term, regulators are expected to continue to scrutinize financial organizations and their relations with stakeholders. Africa, with its peculiarities, urgently requires measures to ensure that these evolving regulations do not stall economic growth and development. While the maintenance of a strong compliance culture is desirable, institutions must put in place clear management systems and processes that identify risks. They should also stabilize their frameworks to manage the emerging risks and how these risks can be mitigated, so as to ensure that they do not miss bankable business opportunities. Afreximbank is contributing to this process in Africa through its Africa Customer Due Diligence Repository Platform (ACDIRP) initiative. ACDIRP provides a centralised single source of primary data required to conduct compliance due diligence and Know-Your-Customer (KYC) checks on African counterparties. By providing such a repository, from which participating lenders can access unique and vital information needed for the process of credit assessment, ACDIRP contributes to reducing operational costs related to compliance and lowers the cost of trade finance for African entities.

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Contemporary Issues in African Trade and Trade Finance

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# THE GLOBALISATION OF CORPORATE GOVERNANCE IN A WORLD OF INSTITUTIONAL INERTIA

Hippolyte Fofack [1]

**Abstract:** Despite the deepening culture of shareholder capitalism other forms of corporate governance, most notably family capitalism and banking capitalism are still playing a key role in the process of capital accumulation and allocation of scarce resources in support of investment and economic growth, both in developing but also in developed economies. In part the coexistence of several forms of corporate governance at different stages of economic development during the globalization of corporate governance standards reflects persistency and institutional stickiness in the midst of evolving corporate governance framework but also the shallowness of capital markets, especially in the developing world.

**Keywords:** Corporate governance, institutional stickiness, shareholder capitalism

## 1. Introduction

Over the past few decades, efforts to reform corporate governance have been dominated by a global push to adopt uniform standards at the global level, irrespective of individual countries' national institutions and stage of development (Siems and Alvarez-Macotela 2014). Increasingly, small and medium-sized enterprises and multinational corporations are being pressed to comply with the provisions of leading corporate governance codes such as Sarbanes-Oxley, the Cadbury rules, guidelines from the OECD (Organisation for Economic Co-operation and Development) and recommendations of the

1 Chief Economist/Director of Research and International Cooperation, The African Export-Import Bank

International Corporate Governance Network. The Dodd-Frank Act adopted by the United States (US) Congress to raise corporate governance standards after the 2008 global financial crisis has added another layer to the global drive for greater transparency and accountability in the financial industry and corporate world.[2]

In practice, attempts to globalize corporate governance standards are counterparties to the rise of multinational corporations and the globalization of finance. As more corporations expanded their footprint beyond their national borders to span multiple countries and continents, it became more difficult for all to comply with multiple region- and country-specific standards of corporate governance. The challenges that arose with the rise of multinational corporations in a world of stark variations in corporate governance standards and institutions were not restricted to the real sector but also reverberated through the financial industry, especially in equity investment, which is increasingly dominated by the globalization portfolio equity investment, as more investors buy shares in foreign stock markets.

As portfolio investors and major investment houses went global, diversifying out of traditional European and US stocks into international companies in fast-growing emerging markets that offered higher yields—especially during the zero lower-bound interest-rate regime in the aftermath of the global financial crisis—they needed certainty about the governance and management standards in the non-resident companies to which they were channelling the savings of their investors and shareholders. Equally, companies seeking equity capital either for financing long-term growth or for balancing an increase in leverage saw that good corporate governance was needed to assure their business integrity and create the market confidence that they required if they were to attract investors.

2 The provisions of the Dodd-Frank Act include one demanding that big banks have more capital and less leverage. Another provision requires that risky financial derivatives be traded on exchanges to ensure that their pricing is more transparent.

However, even though optimizing the allocation of resources and capital in a way that maximizes the risk-adjusted returns to shareholders has been at the heart of capitalism for centuries the process has been generally influenced by national cultural and institutional traditions. Countries practicing capitalism have adopted different principles and practices of corporate governance to shape capital accumulation and deployment of resources in support of sound investment and economic growth (Morck and Steier 2005). In practice on that historical development path, the allocation of capital across and within firms has been entrusted to different types of economic agents, and constrained by very different sets of institutions and rules, depending on the country and period (La Porta et al. 1999).

Even within the leading industrialized economies the rules underpinning the governance of corporations have differed markedly since the early phase of the expansion of capitalism.[3] For example, while shareholder capitalism (one of four types of capitalism—Figure 1), giving primacy to protecting value for shareholders, emerged as the main driver of corporate governance in the US in the late 20th century, the German model of corporate governance, labelled stakeholder capitalism, is more inclusive and remains very popular, despite the move towards the globalization of corporate governance standards over the last few decades (Brandt and Georgiou 2016).[4]

This paper provides a historical overview of corporate governance in a context of globalisation of corporate governance standards and deepening of shareholder capitalism. Following this introductory section, Section 2 reviews the evolving state of corporate governance and shows that despite the globalization of shareholder capitalism, family capitalism and bank capitalism where bankers' oversight substitutes for shareholders' diligence continue to

3 For instance, the protestant ethics of capitalism, which shaped corporate governance in Germany, contrasted sharply with the English model of corporate governance. See, for example, Gerschenkron (1962), Currie-Adler et al. (2013) and Fofack (2014).

4 Stakeholder capitalism considers that production and growth are driven by a wide range of economic agents, including workers, suppliers, governments, customers, management and shareholders, who are all affected by the pursuit of a firm's objectives.

play a key role in the process of allocation of capital and resources in support of investment and economic growth, especially in developing countries but also in a number of advanced economies. Section 3 assesses the interaction between corporate governance and economic development. It shows that at every stage of economic development the corporate world is characterized by the coexistence of different forms of corporate governance. Section 4 reviews the potential implications of the globalisation of corporate governance for African sovereign and corporate entities. The last Section concludes.

## 2. The Evolving State of Corporate Governance

In their seminal study, *A Global History of Corporate Governance,* Morck and Steier (2005) highlight the stark contrasts in types of corporate governance among leading economies with a strong track record of industrialization and structural transformation. They show that the first set of large corporations almost anywhere around the world began as family businesses (see Figure 1). Over time, and depending on the organizational capacity of states to promote industrial policies and on the soundness of banks and strength of financial institutions, new forms of corporate governance emerged, fuelled by the globalization of finance and development of capital markets. During that evolution, corporate governance in leading advanced economies was largely shaped by the prevailing national institutions and socio-political environments.

As an important illustration, it has been argued that the French aversion to shareholder capitalism, in which investment decisions are largely driven by information derived from capital markets and share prices, stems partly from experience in the early 18$^{th}$ century when the implosion of a financial bubble devastated the French economy (Kindleberger 1984). The significant financial losses and accompanying economic and social costs that followed a period of hyperinflation led the government to ban joint-stock companies. In the aftermath of the crash, the Catholic Church played an instrumental role in shaping the views of society about capital markets and shareholder capitalism. France retreated towards a more traditional and conservative financial system regulated by religious directives, which prohibited interest and high-interest speculative debt instruments, even though these would probably have been more appropriate for financing the country's long-term investment and industrial development.[5]

Centuries later, the residual effects of the implosion of that bubble still shape corporate governance in France. Distrust of capital markets, banks and financial innovation has sustained the growth of family capitalism, a model in which the governance of a country's large corporations is entrusted to its wealthiest families, and the soundness of corporations is determined by their capacity to effectively deploy the retained earnings of one company to build others. France's system was so rigid and deep-rooted that the founding families of these business groups controlled the corporate sector for generations, producing a system where wealth remained extremely concentrated and horizontal inequality highly entrenched.

Even though the Paris Stock Exchange has registered a meteoric rise over the last few decades, fuelled by the global convergence towards market-based economies and by the globalization of finance, it has not yet achieved the salience enjoyed by the more vibrant financial centres such as the stock exchanges of London or New York, particularly in the issuance of securities or in financial innovation and engineering. Though banks and financial institutions are playing a growing role in the financing of corporations and risk management, family capitalism is still a key component of capitalism in France.

Challenges associated with family capitalism include inefficiencies in the allocation of scarce resources and, where markets are segmented, a bias against start-ups in access to finance. But this form of capitalism remains very popular and will continue to shape the governance of corporations in years to come. It is still pervasive not just in the developing world, where investors'

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5 Under that rigid financial system regulated by religious directives, the prohibition against interest meant that contracts had to separate the ownership of savings from the streams of revenues they produced. Moreover, as a consequence of the distrust of financial markets during most of the 18th and 19th century, most families in France hoarded gold and silver. Most transactions were *in specie,* with coins accounting for more than half of the money supply in 1885 (Kindleberger 1984).

legal rights are still relatively weak and access to finance is often constrained by policies of financial repression, but also in a large number of advanced economies that have better investment climates and stronger property rights regimes. It is dominant in several countries and regions, particularly in Africa, where small and medium-sized enterprises are the key drivers of informal and formal economies and financial repression is a key constraint to the growth of corporations.[6]

A variant of family capitalism that strongly affects capital allocation in the developing world, and especially in Africa, is one in which individual investors allocate their savings on the basis of trust established within a given community of economic agents. In countries at a very early stage of economic development, characterized by financial repression and a weak institutional and regulatory environment, reliable information on a company's accounting and corporate balance sheet is hard for external parties to obtain. Capital markets also remain very limited, both in terms of market capitalization and number of corporate listings.

Under these circumstances, corporate governance based on group trust has emerged as the best way of allocating scarce resources. Small investors with a mistrust in financial institutions, and in the capacity of relatively weak and less developed capital markets to efficiently allocate resources, may opt to hoard cash and only deploy it in a joint financial arrangement binding an investment group or a development community united by trust. Tontine—a financial model whereby participants usually contribute equally to a common fund and subscribers share an annuity associated with a loan allocated to one of the members—is the most common form of this financial arrangement (McKeever 2009).[7] However, capital allocation based on mutual trust among group members can have only a small impact on a country's growth and economic development and speed of structural transformation, because it is limited by

6 The economic costs of financial repression are reflected in African countries' relatively shallow financial sectors. In the overwhelming majority of African countries, credit to private business remains very low, even by developing country standards (EIB 2016).

7 More recently in the developing world, microfinance has emerged as another means for allocating resources in support of capital accumulation in a context of financial repression.

the size of the group, which in turn determines the level of savings that can be mobilized for capital accumulation and restricts the number of potential beneficiaries. But the endurance of this system suggests that it has useful strengths in circumstances where potential investors lack material information on companies' management performance and corporate governance, because it effectively mitigates risks in the process of allocating resources for capital formation.

Banking capitalism, where bankers' oversight substitutes for shareholders' diligence, remains a dominant driver of growth despite the rise of shareholder capitalism. This type of capitalism delivered impressive economic growth in post-war Germany and Japan, and has played a key role in the transformation of successful emerging economies in Asia (Morck and Steier 2005). Banks are still a major player in continental Europe, where companies rely heavily on financial institutions for corporate funding; more than 80 percent of corporate borrowing in continental Europe is from banks, with only about 20 percent coming from corporate bond markets. In the US in contrast, banks' role in corporate lending has declined steadily, owing to a generalized culture of securitization which has led most banks to sell their loans into the highly developed institutionalized loan markets.

With globalization of finance, the rise of multinational corporations, the expanding size of firms and the increasing role of capital markets, shareholder capitalism is becoming the hallmark of corporate governance (Morck and Steier 2005). The delegation of investment decisions is shaping the relationship between principals and agents, especially in countries where capital markets are more developed. In this model, which gives shareholders primacy, corporate managers pursuing shareholders' interest have the ultimate objective of maximizing the value of the corporation's shares—hence the reference to *shareholder* capitalism (Brandt and Georgiou 2016).[8]

8 Under this model of corporate governance, the interests of shareholders and corporate managers are aligned by granting to managing directors stock options, as well as salaries and other benefits.

State capitalism, or state-guided capital accumulation, has persisted despite the global pre-eminence of free-market economies and the rise of shareholder capitalism. Under this model, public officials strategically deploy revenues collected from individual taxpayers and corporations to provide needed capital to businesses and to promote industrial policy; they are entrusted with supervising corporate managers and may intervene to correct any governance problems that arise. Although its geographical coverage has been shrinking under the globalization impulse, state capitalism is still an important driver of growth in the developing world, especially in countries such as China and India, and in numerous advanced economies in Europe where the state continues to play a major role in strategic sectors such as energy and transport, and even banking and insurance.[9]

In effect despite the global pre-eminence of the free-market economy model, states are still major actors in the economic sphere, accounting for a sizable share of gross domestic product in most countries around the world, in developing and developed economies. More recently, the deployment of fiscal stimulus and quantitative easing under monetary expansion to boost economic growth and stem deflationary threats in leading economies in the aftermath of the Great Recession has demonstrated the continuing large role played by governments in the global environment of deepening culture of shareholder capitalism.

## 3. Corporate Governance and Economic Development

National differences, driven by historical and institutional factors and by the relative strength of banks or financial infrastructure, still influence the governance of corporations and specifically the role played by corporate boards both in management decisions and in the mobilization of resources for long-term investment. The role of boards remains relatively weak in countries

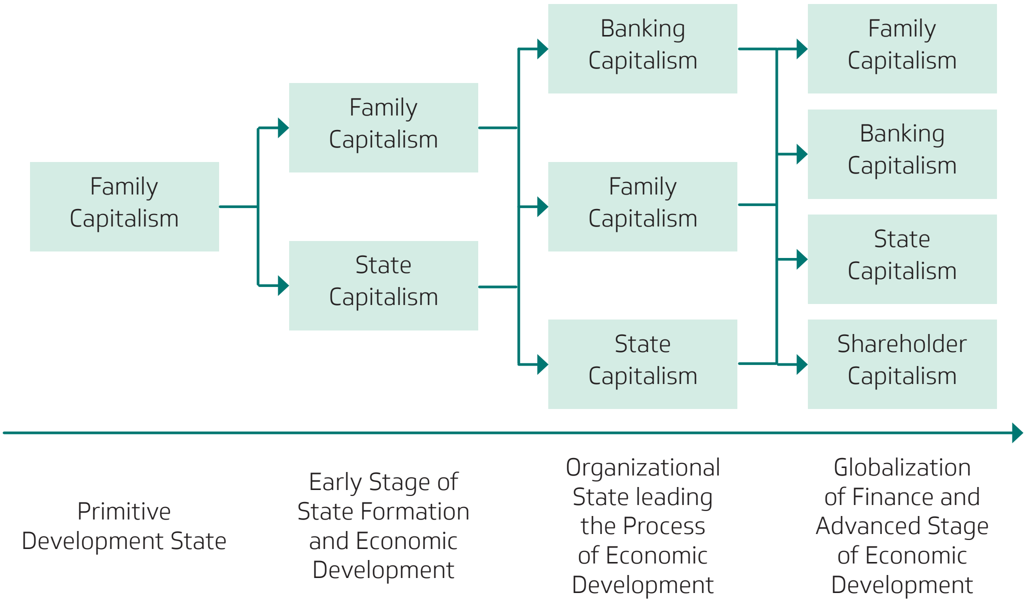
9 For instance, the French government is still a key player and shareholder in strategic industries and corporations, such as Airbus and SNCF in the transport industry or Areva and Total in the nuclear and energy industries.

where family capitalism is strong (emerging markets and most developing economies), and where state capitalism is still very strong (France, China, Russia, India, and other developing countries). But it has grown stronger over time in the UK and USA, two countries with a long history and strong tradition of shareholder capitalism, where capital markets enjoy significant depth.

A move from state capitalism towards shareholder capitalism has been the general global trend, especially in the more advanced economies where capital markets account for a sizable share of capital formation. But even in the Anglo-Saxon model of vibrant capital markets and corporate boards, shareholder capitalism still coexists with other forms of corporate governance, most notably banking capitalism and family capitalism, in a pattern that reflects both the diversity of sources of financing over the life-cycle of corporations and differences in the maturity of corporations. Over time, both banks and shareholders have enlarged their roles in corporate governance, and shareholder capitalism has become the dominant form of corporate governance in countries where capital markets are vibrant and where the process of capital mobilisation to support business growth and development increasingly takes place independently of business owners.

The coexistence of various forms of corporate governance is highlighted in Figure 1 below, which provides a summary of the leading drivers and dominant forms of corporate governance at different stages in the economic development process. It is worth noting that family and state capitalism tend to be very important in the second stage of economic development—early stage of state formation and economic development (column 2). At the third stage—dominated by state, bank, and family capitalism—a strong state with organisational capacity to drive the development process is key. But by the fourth stage—advanced stage of economic development with the globalisation of finance, countries that are more integrated with the global financial system are enabling their multinational corporations to circumvent the constraints imposed by limited domestic resources to obtain financing and capital worldwide.

**Figure 1: Historical Evolution of Corporate Governance along Stages of Development**




Source: Author.

Today in Africa where most corporations are still relatively young and at a very early stage in their development, the corporate sector is still largely controlled by a mixture of state organs, wealthy families and banks. This configuration may partly reflect the financial repression in the banking industry, weaknesses of capital markets, and weak policy and regulatory environments that characterize the overwhelming majority of African countries. Though in a few countries, especially the largest, the growing market capitalisation is allowing resources to be pooled for long-term investments, the supply is still much too small in a region where capital markets are still largely underdeveloped and where the shallowness of the financial sector still limits the financing of corporations [EIB (2016)].

In effect experience with different forms of corporate governance across countries and regions has illustrated the strengths and weaknesses associated with each model. The success of banking capitalism, a model that places confidence in oversight by bankers rather than in shareholders' diligence, assumes that the bankers are consistently altruistic in their commitment to the growth of corporations and are sufficiently competent to monitor the quality of governance and the performance of managers in the corporations they are financing. While such a model has provided the foundation for growth in Europe and Asia, the potential systemic risks associated with it can be seen in the sustained economic contraction of African economies in the 1980s during the rise of non-performing loans, or in the plight of Asian emerging markets in the aftermath of the East Asian financial crisis of 1997-98 when banks were overleveraged [Claessens and Glaessner (1997), Fofack (2005)].

Nor is shareholder capitalism a perfect system. This model shifts the performance-based allocation of capital away from bankers to the market, where share prices are expected to reflect the consensus of investors and therefore to provide a sufficient information base for the valuation of assets. Under shareholder capitalism, where capital is raised through issuance of corporate bonds and stocks to individual and institutional investors, well-managed companies are more likely to obtain resources than are companies that are poorly managed.

But shareholder capitalism also depends heavily on strong regulatory oversight mandating a full disclosure of detailed accounting and financial information by firms, including information on insider shareholding and the extent to which the firms are abiding by policies that proscribe stock manipulation and conflict of interest. The proliferation of conflict of interest and of the principal-agent dilemma—a reflection of the level of disconnect between ownership and management—is a perennial problem under this form of corporate governance.

The collapse of numerous listed multinational corporations and financial institutions in the wake of the 2008 financial crisis, despite their investment-grade ratings, highlighted the risks associated with shareholder capitalism and the extent to which asymmetry of information can cloud the ability of investors to effectively align the rewards of corporate managers with performance.[10] The growing emphasis on corporate due diligence and the systematic push for the implementation of due diligence audits during mergers and acquisitions, as well as during the on-boarding of new customers in the financial industry and banking sector, are responses to weaknesses in corporate governance, especially deficits in the disclosure of information.

## 4. Implications of globalisation of corporate governance for African economies and corporates

While at the global level corporate governance is trending towards shareholder capitalism, in a business environment where more and more multinational companies are drawing on the globalization of finance to tap into a larger pool of resources to meet their growing financing needs, family capitalism and banking capitalism are still the more prominent forms of corporate governance within Africa. Their persistence reflects a number of factors including institutional inertia, a weak regulatory environments, the poor state of African capital markets, and, equally important the coexistence of formal and informal business activities. Africa's informal sector is resilient and impressive in scope, and Africa's formal sector is still largely made up of small and medium-sized enterprises.

Yet the culture of good corporate governance is taking hold within the region. A growing number of companies, including some that are not listed on stock exchanges, are rising to the challenges posed by the globalization of corporate governance standards. Increasingly and across the board (family, state and public corporations) more and more African corporate entities have effective board committees and are producing audited accounts, showing a trend that in the medium and long term will shift the national boundaries of transparency and corporate governance to international levels.

10 In particular, shoddy mortgages were packaged into securities and sold back to potential investors as AAA-rated investment products.

Perhaps these positive developments are motivated by the potential rewards from better corporate governance for liquidity management and for growth. In Africa, where corporations constantly face the existential threats of global competition and disruption in domestic channels of financing, strengthening corporate governance may improve liquidity and risk management, as well as financial soundness. Furthermore, strengthening the culture of corporate governance across Africa could also act to mitigate risk and create the right conditions to leverage more finance from international sources in support of growth and economic development, especially in a region where financial repression has been consistently singled out as a key constraint for economic growth, and where companies are often seen as high-risk destinations by international investors [EIB (2016)].

Despite these inherent benefits, sustaining the continental march towards global corporate governance standards underpinned by shareholder capitalism requires overcoming a number of analytical challenges. These challenges are dictated in part by the limited knowledge about the strength and direction of correlation between corporate governance and economic growth at different stages of economic development, and by the history of corporate governance itself. Regarding the former and by way of informing the choice of corporate governance framework, it will be worth assessing whether shareholder capitalism invariably delivers higher growth performance than other forms of corporate governance, irrespective of a country's stage of economic development.

On the latter, the rise of shareholder capitalism has historically been driven by the strength and maturity of the economy. In particular, capital markets have tended to be more developed in countries at an advanced stage of economic development, where manufacturing output accounts for a sizable share of gross domestic product. In this regard, by putting the financial horse before the manufacturing cart in the African context, where countries are still at a very early stage in their structural transformation, the globalization of corporate governance standards could be fraught with risks. Identifying these risks and assessing their potential implications for African corporates and sovereign entities on the growth and development ladder in the medium and long term could be an interesting question in the ongoing transition towards the globalization of corporate governance.

## 5. Conclusion

This paper provides an overview of corporate governance in a context of globalization of corporate governance standards. It shows that despite the rise of shareholder capitalism during the era of globalisation more traditional forms of corporate governance, most notably family capitalism and banking capitalism, still play a key role in the process of capital accumulation and allocation of scarce resources in support of investment and economic growth. In particular a clear illustration of persistency and generalized institutional stickiness in the midst of evolving corporate governance framework is the coexistence of several forms of corporate governance at different stages of economic development not just in the developing world, but also in the more developed and advanced economies.

In effect, while the culture of shareholder capitalism is taking hold in Africa, with a growing number of corporations, including the ones which are not listed, abiding by global standards of corporate governance and best practices, family capitalism, banking capitalism and state capitalism are still playing a key role in the process of capital accumulation in support of growth and structural transformation of African economies. In part this emerging configuration in the changing African corporate governance landscape is consistent with global trends. At the same time, it reflects the stage of economic development and more importantly the shallowness of the continent's domestic debt markets and its regional capital markets.

In effect with a few exceptions, most notably Johannesburg Stock Exchange, Egyptian Exchange and Nigeria Stock Exchange, regional capital markets lack the size and liquidity required to meet Africa's growing capital needs, and domestic debt markets are either constrained by financial repression regimes or still largely dominated by government securities, notwithstanding recent developments in some countries. Developing and modernizing the financial infrastructure and establishing the right regulatory environment for a steady growth of domestic capital markets within the region will not only deepen the culture of shareholder capitalism, it will also accelerate economic growth and output expansion in the real sector and in the process further enhance the relevance of these regional capital and domestic debt markets.

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Contemporary Issues in African Trade and Trade Finance

CIAT

# THE EMERGENCE OF SUPPLY CHAIN FINANCE AND IMPLICATIONS FOR AFRICA

Anthony Kyereboah-Coleman* & Abdelaziz Elmarzougui β

**Abstract:** Against a backdrop of trade financing gaps and a tightening regulatory environment, this paper introduces Supply Chain Finance (SCF) and surveys recent global and African developments, including SCF's potential benefits for African corporations and small and medium-sized enterprises. It concludes that, although SCF is one of the most cost effective and efficient ways to finance trade, it has largely been undertaken by corporations and financial institutions in advanced economies and in emerging markets in Asia and Latin America. Africa—owing to, for example, low rates of technological adoption, little knowledge of SCF mechanisms, infrastructure deficits and lack of the right technical know-how—shows limited application of SCF.

**Keywords:** Trade Finance, Supply Chain Finance, African Trade

## 1. Introduction

Trade finance is a crucial lubricant for trade in goods and services to flow smoothly. However, given an increasing scarcity of resources, alongside widening gaps in and rising costs of trade finance often tied to increasing volumes of documents required, many are reviewing cost-effective options to optimally finance trade. Supply chain finance (SCF), which provides the means to conduct trade on an "open account" basis, has emerged as one possibility. This paper provides an introduction to SCF and to its potential benefits for Africa, a continent with a widening trade financing gap.

* Research & Statistics Unit, Research and International Cooperation Department, The African Export-Import Bank.

β Strategy & Business Planning Unit, Strategy and Innovation Department, The African Export-Import Bank.

## 2. Traditional trade finance

Trade finance is a broad concept based on several pillars, each with its own characteristics (Table 1).

**Table 1: Pillars of trade finance**

| Payment | Financing | Risk Mitigation | Information |
|---|---|---|---|
| - Secure<br>- Timely and prompt<br>- Global<br>- Cost effective<br>- Leading currencies | - Available to all parties (importer/exporter)<br>- Available at several stages in the transaction | - Risk sharing<br>- Country, bank, institutional and transaction risk<br>- Export credit insurance | - Financial flows<br>- Shipment status<br>- Quality of goods and services shipped |

Source: Malaket 2014.

There are several trade financing forms as shall be discussed presently. With *cash in advance*, importers pay exporters in advance before delivery of goods and services. Even though this form of payment offers the greatest protection to exporters and is suitable where the country risk of the importer is high or the exporter has a leading position over competitors, it is by far one of the riskiest payment options for importers.

In contrast to *cash in advance, documentary credit (DC)/collection* is one of the most secure payment methods in international trade. It involves offering an exporter a conditional payment guarantee from an importer's bank. DC is a written undertaking by an issuing bank that it will honour the payment of a stated sum of money to an exporter (seller) against submission of documents stipulating that all the terms of the DC have been fulfilled. A *collection* is similar to DC with the main difference that participating banks only play the role of an agent of the importer and therefore do not guarantee to honour any payment obligation in the transaction.

Unlike cash in advance, in *open account* trading, the exporter bears the whole risk of the transaction by extending a direct credit to the importer without recourse to an intermediary lending institution. In practical terms, open account involves an exporter's shipment of goods and services before receipt of any payment from the importer and mainly with little or no supporting documentation. Owing to the relatively high risks, exporters may take additional measures such as taking out insurance or securing a guarantee. *Export credit insurance* is a trade finance instrument that provides more protection to the exporter against the importer's credit and country risks, and supports the lending activity of the participating bank by mitigating some of the risks faced in a particular transaction. A *guarantee* may cover some or all of the obligations of the transaction, and can be provided by a third party such as a large corporation (parent company), bank or government.

## 3. Trade Finance and the Changing Regulatory Environment

In the aftermath of the global financial and economic crisis of 2007–2008, trade finance faced challenges relating to increasing economic uncertainty and new regulations. The value of global trade finance was US$10 trillion–12 trillion in 2008 relative to global trade flows of about US$15 trillion at the time (Auboin 2009). During the second half of 2008 and after the crisis, about 15 percent of the decline in international trade was attributed to lack or unavailability of trade finance, while 85 percent was due to a weakening in global demand. In 2011, the global value of bank-intermediated trade finance had fallen to an estimated US$6.5 trillion–8 trillion (BIS 2014). The decline in trade finance credit lines provided by banks is attributed to several factors, including more stringent credit criteria, restrictions on capital allocation and reductions in inter-bank lending, which stemmed from risk aversion reflecting global economic uncertainty. These regulatory changes aimed mainly to protect investors' interests through better supervision and risk management.

As a major area of banking, trade finance has been subjected to new regulatory requirements, including regulations related to Basel III core principles and compliance requirements. The first draft of the Basel III core principles published in December 2009, was received with scepticism by the trade finance community owing to the stringent capital and leverage requirements that it considered incommensurate with the low-risk and short-term profile of the Trade Finance industry. An initial draft of the regulation set strict targets for capital allocated to trade finance. A refinement of the core principles released in January 2014 addressed some of the concerns raised by the industry through adopting more favourable capital and leverage ratios, which was viewed as making capital costs manageable for trade financiers and consequently lowering costs for exporters and importers. But despite the progress at increasing access to trade finance, much still has to be done from the regulatory point of view to address the existing global trade financing gap—estimated at around US$1.6 trillion in 2016 (ICC 2017).

Traditionally, compliance in the trade finance industry was straightforward and limited to the examination of documents. But since the onset of the crisis, more sophisticated compliance regulations have emerged. They encompass measures such as lists for Know-Your-Customer, Know-Your-Customer's Customer and Anti-Money-Laundering, as well as the Office for Foreign Assets Control.[1]

Banks and corporations involved in trade finance are also required to comply with an increasing number of regulations on embargoes set by some countries or entities such as the United Nations, as well as strict adherence to issues related to money laundering, terrorism financing and fraud. The rising costs of such compliance have led to an increase in trade finance pricing. For instance, it is estimated that a single Know-Your-Customer due diligence may cost between US$15,000 and US$50,000 (Long 2014). Adding to costs is the lack of uniformity in regulatory and compliance frameworks from country to country, and scarcity of reliable information. While large trade financiers can cope with these high costs, small banks, and small and medium-sized enterprises (SMEs) face greater pressures.

1 The Office of Foreign Assets Control of the US Department of Treasury "administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States".

## 4. From Traditional Trade Finance To Supply Chain Finance

Over the last few years, SCF has emerged as an alternative to lighten the burden of the changing regulatory landscape and increasing costs. This option has been driven by the rise of open account trading and advances in technology that facilitate financial transactions worldwide, supported by the emergence of Asia as a global trading hub.

Tightening of liquidity by banks, coupled with rising competition over buyers due to lower global demand, has reinvigorated open account trade finance. Although trade on an open account basis has always been one of the major forms of trade finance, the bank-assisted form has overtaken letters of credit. It is projected that, by 2020, about 90 percent of global import financing will be on an open account basis (IFC, 2014). According to most practitioners, the increasing use of this form is likely to be irreversible.

This trend marks a major departure from traditional trade finance, which was document-based. The industry is gradually shifting towards greater digitization. For instance, e-invoicing and Bank Payment Obligation (BPO), which are gaining prominence among exporters, importers and financial institutions, are among the most attractive new products.[2] While some new technologies were driven by the financial community, others were driven by the actions of regulators, such as the Single Euro Payments Area (SEPA) in Europe.[3] The International Chamber of Commerce (ICC), SWIFT and other industry bodies are playing a key role in coordinating global efforts to implement and standardize new concepts in supply chain financing.

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2 BPO is an alternative means to settle international trade transactions and can take the form of an irrevocable conditional undertaking to pay, given by one bank to another. It can also be an electronic letter of credit, providing flexibility and risk mitigation along supply chains. The ICC Banking Commission, with the Society for Worldwide Interbank Financial Telecommunication (SWIFT), has set the Uniform Rule of BPO to establish uniformity of practice in the BPO market.

3 The Single Euro Payments Area is a system implemented by the European Union and the European banking industry where "citizens, businesses and public authorities [in 28 EU member states and 4 member countries of EFTA as well as Monaco and San Marino] can make and receive electronic payments in euro under the same basic conditions, rights and obligations, regardless of their location" in the euro area.

Another key factor is growing intra-Asian and South-South trade and the emergence of Asia as a major player in the global trade finance arena, traditionally dominated by Europe and the United States (US). The need for large multinational firms to secure funding for trade partners—mainly SMEs—in the emerging world has led to a meteoric rise of SCF in China and India, which are among the leading markets for the industry.

**Defining SCF**

SCF essentially refers to the movement of money between all parties involved in supply chains. Forms of open account–based trade finance include securitization, receivables, forfaiting, factoring, and trade credit (a direct credit involving, for instance, a transaction between a parent company and its subsidiary abroad). SCF is closely linked to the movement of goods or services as well as the flow and exchange of information in the form of data and documents and is an opportunity for a win-win outcome for the parties: the buyer optimizes working capital while the supplier improves cash flow, thereby minimizing risks across the supply chain. SCF could also be viewed as a set of solutions through technology that provides a platform to optimize cash flow by allowing businesses to lengthen their payment terms to their suppliers while providing the option for their large and SME suppliers to get paid early.

The main difference between SCF and other traditional forms of trade finance and working capital credit lines is that it deals with a greater number of links across the supply chain, and requires multi-investor/bank structures. SCF also uses technological platforms to automate transactions and track approval of invoices and settlement processes from initiation to completion.

These definitions should not hide the fact that SCF can have very different applications, depending on the institution or country/region where the transaction originates. In fact, there is still no single, working definition of SCF worldwide, despite efforts of the ICC. Some players, for instance, regard SCF as supplier finance, but others focus on the buyer-led aspects (supplier finance or reverse factoring) and the seller-led aspects (receivables finance or factoring).

## A fast-expanding SCF market

Although SCF has been a medium of trade finance since the 1990s, it has evolved tremendously over the last few years, specifically in product and technology development as well as regulations and market penetration and growth. For instance, most active banks on the market reported double-digit growth rates with an average of 70 percent for the period covering 2012 to 2014 (BCR 2015). Growth of the SCF market emanated from the US, Europe, China and India. Latin America is also set to record high growth, driven by South-South trade and intra-regional trade. Table 2 presents a summary of SCF market growth in selected regions.

The market for SCF, which had traditionally been opened to exclusively highly specialized and large financial players, is increasingly opening to local and regional banks, allowing these banks to offer the same products to the same corporate clients. This was a driving force for growth as it allowed banks worldwide to cooperate and consolidate some SCF activities.

**Table 2: SCF market, selected regions**

| | **Europe-Middle East-Africa** | **Asia-Pacific** | **Americas** |
|---|---|---|---|
| Estimated market size by funds in use (€ billion) | 13–17 | 6–10 | 18–22 |
| Estimated annual growth (%) | 15–30 | 30–50 | 15–25 |
| Key sectors using SCF | Food, retail, telecoms | Retail, electronics, textiles, consumer goods | Food, retail, commodities |

Source: Adapted from BCR (2015).

Growth opportunities from SCF have led to a sharp increase in the number of financial institutions offering SCF solutions. Competition between global and local/regional banks has increased with new players mainly from Asia and Latin America changing the global landscape. Unlike traditional trade financing, where liquidity and compliance requirements have exerted upward pressure on pricing, rising competition in SCF has had the opposite effect. In some SCF deals, banks' profit margins were below 100 basis points (BCR 2015). While banks can record losses when structuring SCF deals with large well-rated clients, the SCF market remains an opportunity for them to expand other business and generate high margins with the parties to SCF transactions. These parties could include, for instance, suppliers and buyers in the supply chain of large multinational companies.[4] A large corporation and its global suppliers could create a supply chain before inviting banks to compete for the financing and even pay the corporation a "usage fee".

Another trend shaping competitive forces in SCF is the proliferation in providers of SCF products and services. While the SCF market was until recently dominated by few large financial institutions, smaller players, including tier 2 and tier 3 western banks, are now offering SCF services in their home countries and in emerging countries. Small local and regional institutions in developing countries are also entering the SCF market, aided by technology.

With growing competition and declining margins, SCF providers are now seeking to differentiate and distance themselves from large banks and multinational corporations, in search of market niches offering high value added and high pricing. A focus on small upstream suppliers in developing countries or on a particular international trade corridor are examples of such niches. In 2014, the ICC Banking Commission and five practitioner associations launched an initiative for a global standard framework for SCF.[5] This initiative is expected to culminate in the formation of a Global Supply Chain Finance Forum, which will assist in defining a globally acceptable set of standardized markets terms for the SCF business, and in fostering the creation of a common knowledge

4 In an article published in the World Supply Chain Finance Report (2015), Eugenio Cavenaghi, Head of Trade, Export & Supply Chain Finance, Banco Santander, stated that some financial institutions use their low-margin SCF deals with large Organisation for Economic Co-operation and Development companies to boost penetration of the profitable and highly priced transactions with suppliers (typically SMEs) in developing countries.

5 These banking and trade finance practitioners are: Euro Banking Association, Bankers Association for Finance and Trade, Factors Chain International, International Factors Group, and International Trade and Forfaiting Association.

base and of a set of rules, steps that should help SCF practitioners (including banks, investors, corporations, and information technology providers) to work together for expanding the global SCF market. These steps should also foster dialogue between regulators and market players to lift the credibility of the industry and ensure a smooth transition towards a mature area of the financial services industry.

**Pros and cons of SCF**

SCF presents many advantages for corporations and financial institutions. It provides large and smaller firms with better tools for managing liquidity and cash, giving room to all parties to undertake other transactions without hurting their cash flow. Equally important, automation in a typical SCF transaction has the capacity to ease reconciliation and forecasting processes of the trade transaction. As seen, SCF is technology intensive, with process automation allowing banks to generate steep cost and time reductions relative to traditional trade finance. As document procedures are simplified, SCF allows banks to focus on core banking and financial competencies.

As an emerging industry, SCF has challenges, including domination by large buyers seeking to secure funding for their overseas suppliers; the cost of setting up multiple banking platforms; and reliable statistical data (owing to the range of SCF instruments and difficulties in obtaining data).

## 5. Supply Chain Finance in Africa

Over the last two decades, Africa's trade has grown, reflecting tighter integration with the rest of the world. Its trade with the rest of the world stood at US$847 billion in 2016, up from US$270 billion in 2000 (2017 IMF *Direction of Trade Statistics)*. Yet it accounts for less than 3 percent of global trade, mainly because of product concentration (mainly primary) and behind-the-curve structural transformation, but also the large trade financing gap, estimated to exceed US$110 billion annually.

Widening that gap are the gradual but steady withdrawal of international financial institutions, domestics banks and financial institutions' inability to properly structure trade and trade-related project finance deals, and international banks' withdrawal of letter of credit lines to the continent (and in some cases where available only activated at 100 percent cash collateral). Although the growth in trade has been paced by higher capital inflows and domestic resources, African firms of all sizes in international trade still face liquidity and funding burdens, exacerbated by the crisis and the ending of the commodity super cycle.

**Areas of emergence**

SCF is still emerging in Africa, driven by the need for innovative sources of trade finance (mainly SMEs) and for optimized working capital (primarily large corporations). Although many local and global players are involved in SCF in Africa, local subsidiaries of multinational corporations and international banks dominate the industry, which is underdeveloped, with too few players concentrated in few countries. Some African countries growing in SCF are Cameroon, Côte d'Ivoire, Ghana and Senegal. While SCF in Africa is increasingly used for commodities such as cocoa and coffee, it is mainly used for manufacturing. Zambia implemented an SCF programme for better managing pharmaceutical supply chains through a government contract with IBM, and it involved technical assistance and lending to these supply chains. South Africa, working with SABMiller, adopted an advanced SCF solution to integrate planning across five soft drink plants and breweries; the SCF programme facilitated the production and supply of empty bottles. The retail and telecommunications sectors are set to record high growth rates given their potential and the sophisticated regional supply chains in the sectors.

Africa's structural transformation is poised to increase African firms' and financial institutions' demand for SCF instruments. The need to import capital goods to raise industrial output, for instance, will require them to mobilize SCF and other products. Forfaiting is well suited for this, backed by medium- and long-term receivables.

Firms across the continent, especially SMEs, continue to face difficulties in accessing conventional bank financing for numerous reasons, including risk/security ratios that limit the amount of credit. Developing regional or international SCF would therefore allow Africa to finance trade and perhaps increase its tiny share of global trade. As the SME market is the most important corporate sector in Africa, providing financing for it is critical, including through a vibrant and well-functioning SCF system. Also, as the role of African entities in global trade increases, with large multinational companies operating across the continent, SCF could be critical in reducing the continent's trade financing gap. This is where SCF comes in: it has huge potential to shape agribusiness through value chains, by specialization (and so greater productivity), export diversification, value addition and, more widely, economic development (AfDB 2013). African banks are also set to be important in the SCF market across the continent, expanding their SCF activities in, for instance, receivables/payables financing, inventory and warehouse financing, and trade loans.[6] But too few African banks are providing SCF solutions or promoting a continent-wide SCF market. The scarce information on SCF markets in Africa is problematic for constructing a picture on recent and future trends.[7]

**SCF in Africa—an unmet promise…**

Chief among the reasons for the unfulfilled potential for SCF is lack of infrastructure, especially reliable electric power, transport and telecommunications; lack of a homogeneous (or at least a favourable) regulatory framework; and lengthy processes in promoting SCF in a region where the product still needs to be explained, understood and accepted. Further burdens are geography and fragmented markets, making it hard to achieve economies of scale (distribution and logistics channels remain weak); issues on Know-Your-Customer for suppliers; and cumbersome payment processes. Other factors contributing to the lack of strong supply chains in Africa include higher risk perception of the continent by major global players, and slower technology

6 ECOBANK, a large pan-African bank headquartered in Togo, has set up an SCF programme covering many African countries and aimed at providing working capital solutions for African corporations.

7 At the global level, information on trade finance and on SCF is hard to come by mainly owing to the unwillingness of commercial banks to divulge such information; surveys are the main data collection tool. Likewise, there are no formal statistics on SCF in Africa.

adoption than in developed and other developing countries. Without extensive technological integration of supply chains, financing cannot be optimized to reap the dividends of SCF.

SCF products and instruments are also hindered by lack of efficient internal processes in most African firms, especially SMEs. Even though SCF has begun in some areas, awareness of its potential should be enhanced among corporations and financial institutions. It is also necessary to build capacities by developing SCF technology infrastructure and platforms, and human skills.

**...but with key areas for the future.**

The African sectors most likely to adopt SCF are agribusiness, retail, consumer products and pharmaceuticals. These sectors generally have more developed supply chains and require customized financial solutions, which SCF can offer. Many in the market feel that mobile technology will be key in developing SCF, and so settling cross-border trading transactions using mobile platforms will be a game-changer (BCR 2015), especially as Africa is a leading continent for mobile banking.

## 6. Conclusion

The challenges of traditional trade financing structures have contributed enormously to the development of SCF as a compliment to trade financing tools. Though embraced by most players in international trade, its application has tended to be more pronounced in developed markets (US, Europe) and emerging markets in Asia (China, India) and Latin America.

But despite its potential benefits, use of SCF in Africa is hugely underdeveloped (reflecting small financial institutions, weak supply chains, slow technology adoption and unreliable infrastructure). It is necessary to raise awareness of SCF in Africa and its capacity to unlock the potential of SMEs, mainly through training and communications. Success in overcoming these obstacles could blaze the trail for large-scale adoption of SCF in Africa—helping to plug the trade financing gap and boost trade.

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Contemporary Issues in African Trade and Trade Finance

CIAT

# FACTORING—A FINANCING ALTERNATIVE FOR AFRICAN SMALL AND MEDIUM-SCALE ENTERPRISES[1]

Robert L. Tomusange

**Abstract:** The mainstay of many economies in Africa, small and medium-scale enterprises (SMEs) are perennially constrained by limited access to finance owing to credit rationing and financially repressive regimes. The paper examines the prospects for factoring, which has emerged as a viable source for financing SMEs. After an overview of key institutional and regulatory constraints, it outlines a framework and policy options for developing factoring in Africa, singling out the establishment of a vibrant insurance industry as a key prerequisite.

**Key Words***:* SMEs, Factoring, Africa

## 1. Introduction

The objective of this study is to examine the prospects and obstacles of factoring in Africa. It provides an overview of policies and regulatory reforms to harness factoring's potential on the continent.

Factoring is a financial service—not a loan—where an enterprise sells its accounts receivables 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 (Klapper 2006; Vasilescu 2010). Factoring is an alternate and globally well-established source of external finance suitable for SMEs (Ivanovic et al. 2011; Vasilescu

1 This paper is a summary of a research study conducted by Robert Lumbuye Tomusange, a member of staff of the African Export-Import Bank, in partial fulfilment of the Walden University requirements for the Degree of Doctor of Business Administration. The full research paper accepted in September 2015 is at scholarworks.waldenu.edu.

2010). Unlike traditional loans, factoring is particularly compelling 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 (commonly an SME).

In contrast to domestic factoring, where the parties to the factoring—the client, the factor and the debtor—are usually in the same jurisdiction, 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 from the factoring transaction by way of local market knowledge and local presence.

There are two types of factoring—non-recourse and recourse factoring. With non-recourse factoring, the factor offers a client full credit management service cover on approved debts against the eventuality of being unable to secure full payment of the factored invoices (Vasilescu 2010). With 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, where a factor offers suppliers of a debtor the option to assign or sell their debtor-approved receivables, with a guarantee from the debtor (IFG 2012). In invoice discounting, the financier purchases the sales ledger and advances funds against the approved debt, but does not take on the responsibility for debt collection.

Factoring stands out from other sources of external finance given that it provides enterprises with expedient access to unrestricted finance, irrespective of their credit rating, and with no added guarantee requirements (Vasilescu 2010). Factoring enables firms to have better solvency ratios, better supply chain reputations (given the timely meeting of company obligations), and improved sales volume (given 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 debts and exchange risk, improved profitability due to reduced credit risk, and reduced leverage and worries associated with being over leveraged (Ivanovic et al. 2011).

According to Factors Chain International, the volume of global factoring in 2014 was estimated at €2.35 trillion, representing 6 percent growth from the previous year and equivalent to 3.7 percent of global gross domestic product (FCI 2015). Factoring is used in more than 60 countries, with some 3,000 global providers of significant scale, employing some 53,000 people and advancing over €340 billion to some 530,000 factoring clients in 2013 (IFG 2014). Alongside China, the global receivables market is dominated by traditional European players—the United Kingdom and Ireland with a 15.1 percent global market share, France 9.2 percent, Italy 8.2 percent, Germany 7.9 percent and Spain 5.3 percent (IFG 2014). Despite its potential benefits, factoring activity in Africa is extremely low, with a less than 1 percent share of the global market and worth about €21 billion, with South Africa alone accounting for €15.9 billion (FCI 2015). Other countries on the African continent active in factoring include Egypt, Mauritius, Morocco and Tunisia.

The cost associated with factoring is the main downside. These costs are based on different proportions and include a factoring fee usually ranging from 0.2 to 4.0 percent of assigned claims, in addition to annual interest usually ranging from 7 to 11 percent of the funded amount as well as an administrative fee. Further, factoring can result in the loss of direct communication and relationships with business partners or suppliers (Ivanovic et al. 2011). In the event of delays by debtors to honour payment obligations, factors may take aggressive action against the buyer, antagonizing the buyer–seller relationship (Vasilescu 2010). Disagreements are also likely to emerge between the factor and client in cases where product quality is not satisfactory, and the debtor chooses to return the goods to the client or imposes penalties (Ivanovic et al. 2011). In some cases, buyers may be unwilling to involve a third party (a factor) in the buyer–supplier relationship (Ivanovic et al. 2011).

Still, the global factoring industry is flourishing, though performance has been suboptimal in some markets (IFG 2013; 2014). Although an insignificant player in the global factoring market, Africa has over the past 10 years shown average annual growth of 14.2 percent (faster than the global average of 8.6 percent) from €5.9 billion in 2001 to about €20 billion in 2012 (Oramah 2013).

## 2. Africa's Factoring Industry Development Framework

This study employs a qualitative and phenomenological methodology and research design. Experiential data were collected using semi-structured interview instruments with 22 executives providing or promoting factoring in 16 African countries: Cameroon, Côte d'Ivoire, Egypt, Gabon, Ghana, Kenya, Malawi, Mauritania, Mauritius, Mozambique, Senegal, South Africa, Tanzania, Tunisia, Zambia and Zimbabwe. Analysis was done within the Braun and Clarke (2006) thematic approach, from which the following four main themes emerged.

**Supply-side conditions**

Study participants strongly asserted that factoring offers a high-value proposition in financing African SMEs. The main attraction, in addition to employing much-needed working capital, comes from factoring's value-added services: protection against non-payment of invoices, professional commercial collection services, and professional credit risk management to assess the creditworthiness of buyers. Yet factoring suffers from perception issues: Some participants perceived it to be expensive, a product of last resort, or one to use during financial distress; others considered it similar to conventional lending. Further, and as a result of the lack of regulation or industry standards in some markets, factoring suffers a "loan shark" perception reflected in its excessive pricing and manipulation by some factors.

However, participants concurred on the prospects and potential for factoring, which they expect to play a significant role in financing SMEs in Africa. These prospects are informed by the rate of returns, which are relatively high, the booming private sector and, especially, the growth of SMEs.

But despite these prospects, factoring is still a country-level phenomenon with factoring at the domestic level accounting for 70–90 percent of total factoring in the region. In part, this bias to national markets reflects the nature of SMEs, which tend to carry out most of their activities locally. However, international factoring is expected to gain prominence as a trade finance instrument regionally. The projected rise of international factoring is attributed to the export-oriented nature of the continent and the emerging global trend towards an "open account receivables finance" culture for international trade. Recourse factoring, though not the ideal form for SMEs, is projected to grow in Africa given the lack of financial information on the part of sellers and lack of credit risk cover.

Findings also suggested that reverse factoring has a special appeal to African SMEs, in part because they often supply large, creditworthy buyers with a strong balance sheet. The capacity to support suppliers through the provision of guarantees is also a very important driver. At the same time, the study suggests that the involvement and cooperation of an investment-grade buyer in a factoring transaction significantly reduces the risk, making reverse factoring more appealing for financing SMEs.

Banks that tend to be well capitalized in the region have been singled out as key potential facilitators of factoring in Africa (Beck and Cull 2013). In practice, most banks in Africa see factoring as risky and have been reluctant to venture into it. Pricing has thus emerged as one of the major impediments to expanding factoring in Africa. Other bank-related factors include the rigor involved in deploying factoring transactions, and the broad nature of effective factoring services requiring the provider to offer a range of other services, such as debt collection and credit protection services, some of which would require banks to undertake substantial and elaborate investments in back-office processes and systems.

Independent (non-bank) factors were identified as other potential drivers of factoring in Africa. In fact, despite the relatively higher barrier to entry into the African factoring market, the continent's industry still has only a few independent factors, most of which are small, under-capitalized and constrained by the size of business they can do (Oramah 2013).

The study also showed that international factoring companies have a role in promoting factoring in Africa. For instance, through joint ventures local companies could leverage the financial and technical capabilities of the international factor, and the foreign entity could leverage the local market knowledge and operational and regulatory capabilities of the local factor. There is evidence of international factors collaborating with banks in Egypt, Kenya, Morocco and Zimbabwe. Yet despite the attractiveness of the factoring industry and expected profitability, the study showed little competition in some African markets.

**Demand-side conditions**

Growth in African economies, largely driven by growth in SMEs and the private sector, has created considerable demand for innovative financing options, including factoring. Emerging legislation, including the affirmative action Black Economic Empowerment in South Africa, where large corporations are required to give a quota of business transactions and contracts to small businesses, is creating opportunities for factoring. Additionally, local content initiatives implemented by some governments, including Angola, Botswana, Ghana, Nigeria and Zambia, where certain services and supplies have to be provided by local providers, with most of the local providers being SMEs, are likewise driving the growth of SMEs and raising prospects for factoring. The emergence of the African private sector, an improving regulatory environment and the rapid expansion of the African economy is fuelling the growth of supply chains in Africa, which also provides opportunities for factoring.

The much-touted rapidly rising middle class in Africa—regarded as the second-fastest growing globally—has the potential to generate commensurate expansion in retail activities and household consumption, possibly leading to increased demand for factoring services. African countries that offer the greatest market prospects include Cameroon, Côte d'Ivoire, Egypt, Ghana, Kenya, Morocco, Mozambique, Nigeria, Senegal, South Africa, Tunisia, Uganda, Zambia and Zimbabwe. These countries have taken steps to introduce factoring regulations to create the right environment for growth in factoring. Some sectors identified to drive the industry in Africa include oil, mining and other extractive industries; telecommunications; and the retail sector. At the same time, fast expanding intra-African, South–South and international trade could be an additional driver. International factoring will facilitate intra-African and international trade with the potential to replace the use of expensive letters of credit, which currently dominate trade finance structures.

**The business environment**

In line with existing empirical evidence from other studies (such as Brinsley 2013; Oramah 2013; Satta 2006) the study identified legal, regulatory and tax considerations as major impediments to the growth and development of factoring in Africa. Faced with legal loopholes, specifically on assigning receivables in many parts of Africa, better factoring legislation is a prerequisite for ensuring that factors seeking finance against receivables can become uncontestable owners of the receivables. Challenges in enforcing factoring solvency laws and the lack of legal precedents where courts provide rulings in favour of the factoring industry constrain factoring's growth.

The study's findings also suggest that regulatory deficiencies impede factoring growth in some African countries, where there seem to be difficulties in obtaining regulatory approval and licenses to operate factoring businesses. For instance, the Reserve Bank of Zimbabwe requires factors to obtain a banking licence, because factoring is not treated as an asset purchase but as money lending, while in Ghana, factoring companies have difficulty in being classified as either specialized credit institutions or non-banking financial institutions. There is limited awareness, knowledge and information about factoring in some parts of Africa—to harness the industry's prospects, this needs to be changed.

Factoring skills are essential for conducting factoring operations, with expertise required to run a robust back office infrastructure that ensures proper internal checks in managing factoring invoices. Factoring requires an information technology (IT) platform or system to monitor back-office operations and payments. Most participants highlighted the challenges of accessing affordable technology with which to provide factoring services.

Study findings suggested that factors lacked access to affordable capital to refinance factoring operations. Finance is often not easily accessible, especially for non-bank independent factors, and when available, the cost is too high. In

Ghana, high interest and inflation rates render factoring very expensive. More widely, many parts of Africa lack an open account trade culture, mainly because of the lack of trust.

**Facilitating institutions and industries**

Debtors are critical participants in the success of factoring. Debtor cooperation is required, in particular, in confirming and honouring the assignment and channelling payment for the goods or services to the factor as opposed to the supplier. Some debtors in Africa are not willing to support factoring transactions. For instance, in Kenya, some debtors do not want to acknowledge there is a third player—the factor—and refuse to confirm or honour any assignment of contract proceeds. Similarly, in South Africa, some of the larger buyers—typically the big mining companies or municipalities—impose non-assignment clauses in purchase agreements that preclude their suppliers from selling or ceding their debtors' books. In Nigeria, many multinational debtors do not accept assignment of receivables, as some have their accounts payable processes automated and controlled globally, with little decision latitude for local managers. And in Egypt, some participants suggested that some buyers (debtors) were uncooperative as most were neither willing to provide financial information for an assessment to be carried out before granting a facility to the suppliers, nor willing to provide verification for an invoice.

A vibrant credit insurance industry is a key prerequisite for factoring development in Africa. Factoring has a symbiotic relationship with credit insurance, which is required to cover certain kinds of payment risk to enable factoring activities to flourish. Credit insurance is a precondition for provision of non-recourse factoring. The study revealed that the credit insurance industry is non-existent in many African countries and, where available, the cost of credit risk cover is prohibitive. Additionally, the study suggested that industry associations play a key role in stimulating factoring and in acting as a vehicle for educating both the market and potential financiers. At the same time, success will depend on the ability of the industry association to raise awareness about the benefits of factoring across the continent.

African governments and their agencies are critical players in assuring a conducive environment for the growth of factoring, by addressing impediments in the business environment. As an example, they should establish credit registries for assignments to enable factors to ascertain the priority of assignment without having to conduct detailed due diligence searches (and hence decrease the likelihood of financing invoices already financed by a third party). African governments should also establish credit reference bureaus where factors can find information for assessing the credit risk of buyers. Most African countries do not have a credit reference bureau and for some that do, not all the banks consistently supply information on their borrowers.

Multilateral organizations, development banks, donor agencies, civil society organizations and other development agencies can also help promote the growth of factoring in Africa. Additionally, professional business advisors including business support providers, auditors, lawyers, accountants, consultants and bankers were identified by participants as parties that can stimulate factoring in Africa through the range of services they offer enterprises.

## 3. Recommendations for Action

Despite the growth potential of factoring on the continent, low levels of awareness, regulatory and legal flaws, banking sector apathy, high entry barriers, lack of affordable factoring technology platforms and limited credit information and insurance are some of the hurdles. To overcome them, this paper recommends that regulators, financial institutions and factoring associations—as well as civil society and other professional associations—champion the growth and use of factoring.

**Regulators.** As regulators, governments need to address the legal barriers that undermine factoring and SME growth in Africa and adopt pro-factoring and solvency laws, for instance, waiving documentary taxes and registration charges on receivables and lifting bans on assignment or cession. The Factors Chain International and International Factors Group (FCI/IFG) law on factoring could be used as a blueprint. Regulators would also be advised to implement measures that ensure the expedient enforcement of factors' rights by improving court processes and issuing objective judgements that foster the factoring industry. African governments, with financial institutions, should set up and maintain credit reference bureaus to facilitate access to information on enterprise credit standing and borrowing habits.

**Financial institutions.** Local and foreign banks that have the greatest potential are encouraged to take a greater stake in factoring and manage operational risk through white-labelling and outsourcing non-core factoring activities—such as back-office operations for which they may lack skills or technology—to external parties. In this way, the banking industry would help to lower the costs associated with factoring services and to curb "loan shark" tendencies and other negative product perceptions. Development financial institutions like the African Development Bank should champion factoring, both intellectual and financial capital, and partner with the factoring industry to advocate for, fund and promote factoring and SME development in Africa.

**Factoring associations.** Investors should seize first-mover advantage and set up factoring companies in Africa to tap into the business opportunities presented by fast-emerging African SMEs, supply chains, middle classes, and domestic and international markets. African factoring companies should form joint ventures with international factoring companies for synergies. These partnerships should extend to financial institutions, civil society and other professional associations to form strong lobbies which would argue for improvements in the regulatory environment and industry standards, and promote the features and benefits of factoring to a wider business audience.

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Contemporary Issues in African Trade and Trade Finance

CIAT

# REGIONAL TRADE AGREEMENTS AND THE WORLD TRADE ORGANIZATION

Yusuf Daya[1]

**Abstract:** Africa has committed to establishing a Continental Free Trade Area (CFTA) to boost intra-African trade and deepen economic integration. While initially, regional economic communities (RECs) emerged as a means for deepening economic integration, more recently rationalizing the RECs has become the preferred option for establishing the CFTA, as evidenced by the establishment of the Tripartite Free Trade Area. By affording preferences to select countries, these Regional Trade Agreements (RTAs) appears to run contrary to multilateral trade principles. Yet the World Trade Organization (WTO) can allow for such preferences. As African countries negotiate the CFTA and deeper integration it is necessary to ensure that the approach taken and agreement concluded reflect the requirements of international trade law.

**Keywords:** Regional Integration, Regional Trade Agreements, Free Trade Area, Customs Union, World Trade Organization

## 1. Introduction

The 18th Ordinary Session of the Assembly of Heads of State and Government of the African Union, held in Addis Ababa, Ethiopia in January 2012, adopted a decision to establish a Continental Free Trade Area (CFTA)—by an indicative date of 2017—as a means of boosting intra-African trade and deepening economic integration. Negotiations were launched in June 2015. The CFTA aims to bring together 55 African countries with a combined population of more

1 Trade Policy and Market Access Unit, Research and International Cooperation Department, The African Export-Import Bank.

than 1 billion and a combined gross domestic product of around US$3.4 trillion. The means for achieving the CFTA is through rationalizing existing free trade areas established under regional economic communities (RECs), which are regional groupings of African states formed with the primary objective of facilitating regional economic integration among members and through the wider African Economic Community.[2] The African Economic Community was established under the Abuja Treaty (1991), which with its predecessor, the 1980 Lagos Plan of Action for the Development of Africa, proposed the creation of RECs as the basis for wider African integration and as the framework upon which regional and eventual continental integration would be established. A central feature of the RECs is to set up preferential trade arrangements among members by creating free trade areas (FTAs) and/or customs unions (CUs) to support the eventual establishment of the African Economic Community.

Trade arrangements such as FTAs or CUs that seek to promote economic integration by affording trade preferences to selected countries have been a common feature of the global economic landscape for 50 years. Recently, and partly owing to the slow progress on the Doha Development Round of Negotiations, the global economy has seen a proliferation of Regional Trade Agreements (RTAs). As of 1 July 2016, 635 RTAs had come to the notice of the World Trade Organization (WTO).[3] This proliferation, globally and in Africa, raises questions over the relationship between these RTAs and the WTO-based multilateral trading system.

The first is that the principle of RTAs seeking to afford regional trade preferences to a selected group of countries appears to run contrary to that of non-discrimination, which underpins the multilateral trading system of the WTO. Article I of the General Agreement on Tariffs and Trade (GATT) obliges WTO

2 The African Union recognizes the following eight RECs: Arab Maghreb Union (UMA); Common Market for Eastern and Southern Africa (COMESA); Community of Sahel–Saharan States (CEN–SAD); East African Community (EAC); Economic Community of Central African States (ECCAS); Economic Community of West African States (ECOWAS); Intergovernmental Authority on Development (IGAD); and Southern African Development Community (SADC).

3 Counting goods, services and accessions separately. Of these, 423 were in force (http://www.wto.org/english/tratop_e/region_e/region_e.htm).

Members to extend Most Favoured Nation (MFN) treatment to all WTO Members. Under WTO agreements, countries cannot normally discriminate among their trading partners and therefore cannot generally grant another country a special favour (such as a lower customs duty rate for one of their products) without doing the same for all other WTO Members. This principle is known as MFN treatment. Affording preferential treatment to a selected number or grouping of countries, under a regional integration agreement or RTA, therefore appears to run contrary to this rule. However, WTO agreements, particularly the GATT, accommodates and allows for the conclusion of preferential agreements that have as their rationale and purpose discrimination against non-members of the RTA.

The second question is whether RTAs contribute, or are stumbling blocks, to multilateral trade liberalization ambitions as espoused by the WTO. The answer remains uncertain, although the WTO recognizes and accommodates the existence of RTAs.[4]

After a review of the different types of RTAs allowed under WTO law, this paper examines the conditions under which such agreements will benefit from exemptions from the WTO core principles of MFN Treatment and Non-Discrimination. It also highlights the types of trade agreement concluded by African countries at regional level under the RECs and at continental level under the CFTA, and in so doing discusses the requirements for their compatibility and legitimacy under WTO law, both for internal requirements and for requirements vis-à-vis third countries.

## 2. Types of Regional Trade Agreements and the Primacy of WTO Law as a Constitutional System

In 1961, Bela Balassa espoused a theory of economic integration that sets out a conceptual framework within which to view or describe integration arrangements.[5] According to that framework, RTAs can be generally classified

4 Damro C, The Political Economy of Regional Trade Agreements, in Regional Trade Agreements and the WTO Legal System, eds. Bartels L. and Ortino F, 2006, Oxford University Press.

5 Balassa B, The Theory of Economic Integration. Homewood, IL: Richard D. Irwin Press. 1961

by the level of integration they aim for, encompassing a wide variety of agreements ranging from FTAs and CUs to more partial coverage or limited-scope agreements (Gantz 2004).[6] The traditional conception, as suggested by Balassa, is of regional integration following a linear or unidirectional approach progressing from an FTA to a CU, common market, monetary union and eventually a political union.

This approach has been adopted by several African RECs, including the Common Market for Eastern and Southern Africa (COMESA), the East African Community (EAC), the Economic Community of West African States (ECOWAS) and the Southern African Development Community (SADC). It is also the approach driving the African Union's continental integration agenda. The characteristics of each stage can be broadly described as follows:[7]

- FTAs: These have eliminated trade barriers between members (i.e. tariffs and quotas) and each country retains its own national tariff regime against non-members;

- CUs: Tariffs and quotas are eliminated between members and all members apply a common external tariff against non-members;

- Common market: A CU plus the free movement of factors of production (i.e. labour and capital);

- Economic union: A common market plus the harmonization of national economic policies (tax rates, common monetary and fiscal policies, monetary union); and

- Political union: central, supranational political authority whose decisions bind member states.

6 Gantz D.A., Regional Trade Agreements, in The Oxford Handbook of International Trade Law, eds. Bethlehem, McRae, Neufeld and Van Damme, 2009, Oxford University.

7 Adapted from Uzodike, U.O., The Role of Regional Economic Communities in Africa's Economic Integration-Prospects and Constraints, 2009, Africa Insight vol. 39/2. Pages 26-42

Some 84 percent of RTAs are FTAs, and the rest are either CUs or partial scope agreements. In practice, aspects of each of these stages can be cross-cutting, with FTAs having elements of a CU and a CU elements of deeper integration arrangements, among others. This unidirectional approach to integration does not, however, capture the dynamic aspect of integration and ignores the multitude of factors that may inform an integration arrangement. Still, these stages provide a useful conceptual framework for examining the process and depth of economic integration.

Countries may enter into a variety of trade agreements that differ both in content and scope of coverage. The freedom of states to choose the type of RTA is entrenched in the general principle under international economic law allowing states freedom essentially to enter into agreements of any kind and content.[8] While there is no explicit recognition of a hierarchy of laws that would confer WTO law primacy over RTAs, Cottier and Foltea[9] demonstrate that as a consequence of WTO law explicitly providing the conditions for deviation from WTO norms, a hierarchical relationship exists between WTO law and RTAs under Article 41 of the Vienna Convention on the Law of Treaties (VCLT)[10]. In practice, this suggests that RTAs are only compatible with Article 41 of the VCLT if they comply with the provisions and conditions provided for in WTO law. In other words, WTO law assumes primacy over RTAs in the same way as domestic law would be subject to constitutional law.[11] This primacy of WTO

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8 Cottier T. and Foltea M., Constitutional Functions of the WTO and Regional Trade Agreements in Regional Trade Agreements and the WTO Legal System, eds. Bartels L. and Ortino F, 2006, Oxford University Press.

9 Ibid at 7.

10 Article 41 of the Vienna Convention on the Law of Treaties provides that: Two or more of the parties to a multilateral treaty may conclude an agreement to modify the treaty as between themselves alone if:
   (a) the possibility of such a modification is provided for by the treaty; or
   (b) the modification in question is not prohibited by the treaty and:
      (i) does not affect the enjoyment by the other parties of their rights under the treaty or their obligations;
      (ii) does not relate to a provision, derogation from which is incompatible with the effective execution of the object and purpose of the treaty as a whole.

11 Cottier and Foltea suggest that from a functional point of view, WTO principles and rules structure the shape and contents of preferential agreements with a view to support trade creation.

law therefore confers a "constitutional" nature on WTO law and in case of any conflict between an RTA and WTO law, the RTA would have to cede.

Gathii supports this view of WTO law being "constitutional" on the basis that its laws are binding on Members; it has a judicial enforcement mechanism that manifests itself in the binding system of dispute settlement; and its laws affect private entities and persons. The implication of this for the CFTA and REC integration arrangements, given that the vast majority of African countries participating in RECs and negotiating the CFTA are WTO Members, is that they are obliged to comply with WTO law governing RTAs.[12] The implication for African countries engaged in CFTA negotiations is that all country Members of the WTO must comply with WTO law governing RTAs.

## 3. WTO Law and RTAs

Accepting the primacy of WTO law over RTAs, the question then becomes: What type and nature of RTAs does WTO law allow, and under what conditions are RTAs compatible with WTO law? Given that RTAs detract from the WTO MFN principle, WTO law recognizes the existence of RTAs by creating exceptions to the principle of MFN and by providing a framework within which preferential agreements may be concluded by Members so as not to undermine multilateral trade liberalization. For trade in goods, Article XXIV of the GATT 1994 and the Understanding on the Interpretation of Article XXIV of the GATT 1994 sets out the main exceptions to the MFN principle and the conditions to be met for RTAs to be compliant with WTO law.

The WTO defines RTAs as "trade agreements between two or more partners". They include FTAs and CUs or any interim agreements leading to the formation of an FTA or CU.[13] Although, Article XXIV makes no specific mention of common markets or economic unions, these forms of RTAs are consistent with the WTO given that they are both extensions of a CU and take the level of integration

12 Gathii, T.G., African Regional Trade Agreements as Legal Regimes, Cambridge International Trade and Economic Law, 2011.

13 Article XXIV of the General Agreement on Tariff and Trades 1947. Available at http://www.wto.org/english/docs_e/legal_e/legal_e.htm

beyond that of a CU.[14] The GATT therefore sets a "minimum requirement" for FTAs and CUs, which common markets and economic unions would generally exceed. The compliance of such RTAs will consequently also be dependent on compliance with requirements for a CU, and will be discussed in that context.

Based on the provisions of Article XXIV, preferential arrangements for goods in terms of WTO law are only possible under the definitions of an FTA or CU or interim arrangements leading to the formation of an FTA or CU. Preferential, particularly non-reciprocal, agreements do not exist under WTO law *per se* but do exist through recourse to general and temporary exceptions under Article IX (3) of the WTO Agreement or through the provisions of the Enabling Clause.[15] The analysis of compatibility therefore focuses extensively, though not exclusively, on FTAs and CUs, as these are the most prevalent form of integration across Africa, and the most prevalent principles and rules pertaining to regional integration and preferential trade agreements as provided for in WTO law.

Article XXIV of the GATT, in particular the provisions of Article XXIV (4), recognizes that integration between parties with an RTA can be beneficial to free trade. It provides that the "purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories".[16] Mathis highlights that this "purposive" expression highlights that an FTA and CU must comply with internal requirements (facilitate trade between constituent members) and external requirements (not raise barriers to the trade of other contracting parties).[17] These requirements for compliance

14 L. Grimmet, Protectionism and Compliance with the GATT Article XXIV in selected Regional Trade Agreements" (thesis submitted to Rhodes University, 1999). Available at http://eprints.ru.ac.za/208/01/grimett-thesis.pdf

15 The Enabling Clause is an extension of the Provisions for the Special and Differential Treatment for Developing and Least-developed Countries. The Enabling Clause falls under the decision on "Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries" which was adopted in 1979 during the Tokyo Round.

16 Article XXIV(4) of the GATT, available at http://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf

17 Mathis, J.H., Regional Trade Agreements and Domestic Regulation: What Reach for Other Restrictive Regulations of Commerce, in in Regional Trade Agreements and the WTO Legal System, eds. Bartels L. and Ortino F, 2006, Oxford University Press.

are reflected in Article XXIV (5)–(8).[18] Gantz points out that once an RTA has met the substantive requirements of Article XXIV (5)–(8), it is not necessary for the RTA to satisfy a test of its purpose to be consistent with the GATT.[19] The test of compliance for an FTA or CU with the GATT is therefore limited to compliance with the substantive provisions contained in Article XXIV (5)–(8) of the GATT 1947 and the Understanding on the Interpretation of Article XXIV of the GATT 1994.

As indicated, Article XXIV (8) defines an FTA and CU for the purposes of the GATT. Being definitional in nature, any examination of compatibility with the WTO must therefore begin with this article,[20] which sets out the internal requirements for the formation of a CU or an FTA. For a CU it is required that "duties and other regulations of commerce … are eliminated with respect to substantially all the trade between the constituent territories of the union, or at least with respect to substantially all the trade in products originating in such territories."[21] Additionally, for a CU, it is required that members apply "substantially the same duties and other regulations of commerce … to the territories not included in the union."[22] For an FTA it is required that "duties and other regulations of commerce … are eliminated on substantially all the trade between the constituent territories in products originating in such territories."[23]

Given this, it is apparent that the first requirement for an RTA to be compatible with the GATT is that it needs to cover substantially all trade in goods originating in territories of members of the RTA. The meaning of "substantially all trade" in Article XXIV (8) has given rise to much discussion over the years. To date, WTO

18 Paragraph 1 of the Understanding on the Interpretation of Article XXIV of the GATT 1994 requires require that all customs unions, free-trade areas and interim agreements leading to the formation of a customs union or a free-trade area must satisfy the provisions of paragraphs 5,6,7 and 8 of Article XXIV, GATT (1947).

19 Ibid at 4.

20 Ibid at 12.

21 Paragraph 8(a)(i).

22 Paragraph 8(a)(ii).

23 Paragraph 8 (b).

Members have been unable to agree on the proportion of trade that amounts to "substantially all trade", or how it is to be measured within an RTA.[24.]

Collier and Foltea highlight that two approaches are generally posited: first, a qualitative approach that requires the elimination of restrictions with respect to every major sector of the economies of the parties to the RTA;[25] second, a quantitative approach, which relies on a statistical threshold, for example, requiring the elimination of restrictions with respect to a predefined percentage of trade. Citing the WTO Panel and Appellate Body Report in the *Turkey-Textiles* case and the definition of substantial sectoral coverage in the WTO General Agreement on Trade in Services (GATS), they suggest that "substantially all trade" involves a combined qualitative and quantitative consideration that would apply to both CUs and FTAs. While the words "substantially all trade" dictate how much trade must be liberalized within an RTA, the words "duties and other restrictive regulations of commerce" describe the types of restriction to be eliminated.[26]

A second question that arises from the definition is: Which trade restrictions are to be eliminated? According to Article XXIV (8)(a)(i) and (b), the parties to a CU or FTA must eliminate duties and other restrictive regulations of commerce on substantially all trade within the RTA. Similar to the questions of substantially all trade, WTO Members have not agreed on the meaning of "duties and other restrictive regulations of commerce" nor has any panel or Appellate Body reports defined it. Mathis examines the concept in detail and suggests that in determining which regulations constitute other restrictive regulations of commerce it is not so much the *form* of a regulation that is important but rather its *effect* on commerce.[27] The requirement of elimination

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24 Lockhart, N. and Mitchell, A.D., Regional Trade Agreements under GATT 1994: An exception and its limits, in Challenges and Prospects for the WTO, Mitchell D.A., 2005. Available at http://www.worldtradelaw.net/articles/lockhartmitchellrta.pdf

25 Ibid at 7.

26 In Turkey-Textiles, the Appellate Body noted that "substantially all the trade" is not the same as all the trade, but that it "is something considerably more than merely some of the trade". WTO Appellate Body Report, Turkey-Textiles WT/D534/AB/R, adopted 19 November 1999, para 49.

27 Ibid at 18.

would therefore appear to apply only to regulations that have a "restrictive" effect on commerce, irrespective of whether the regulation imposes duties or takes some other form.[28]

Article XXIV (5) sets out the external requirements for the formation of an FTA or CU. Paragraph 5(a) allows for the formation of a CU if the duties and other regulations of commerce imposed when forming the CU, are on the whole, not higher or more restrictive than the general incidence of those applicable in the constituent territories before the formation of the CU. Paragraph (2) of the Understanding on the Interpretation of Article XXIV of the GATT 1994 provides the methodology to be applied for the assessment of the incidence of duties and other regulations to commerce to determine whether or not such duties or regulations are on the whole not more restrictive.[29]

Paragraph 5(b) allows for the formation of an FTA if the duties and other regulations of commerce maintained in each of the constituent territories, and applicable at the formation of the FTA to the trade of other WTO Members, are not higher or more restrictive than those existing before the FTA was formed. While the market access rights vary slightly for the different types of Agreements, from these provisions it is clear that the conclusion of an RTA must not be achieved at the expense of other WTO Members specifically and multilateral liberalization in general.[30] Paragraph 5(a) and (b) therefore seek to ensure that RTAs have a neutral impact on other WTO Members and do not act to unduly divert trade.[31] For an RTA to be compatible with the GATT, it will therefore be necessary that the conclusion of the RTA does not result in more severe barriers to trade for other WTO Members. Additionally, Article XXIV (5)(c) requires that any interim agreement leading towards the establishment of a CU or FTA should include a plan and schedule for the formation of such a CU

28 Ibid at 25.

29 Paragraph 2 of the Understanding on the Interpretation of Article XXIV of the GATT 1994.

30 Cottier and Foltea highlight that the market access rights for a CU is that trade restrictions will not on the whole be more severe than the general incidence of the duties and regulations prior to forming the CU, while for an FTA, such restrictions must not be higher in any instance.

31 Ibid at 12.

or of such an FTA within a reasonable length of time, generally limited to 10 years.[32]

Gantz highlights that the exception to the MFN principle is important enough for the GATT to require a series of notification and transparency requirements to ensure compliance with Article XXIV.[33] Article XXIV (7)(a) of the GATT requires that a party to an FTA or CU must notify GATT contracting parties and make available to them any information regarding the proposed CU or FTA. Making such information available, GATT contracting parties can submit any reports and make recommendations as they deem suitable.[34] For interim agreements, a working party constituted of GATT contracting parties may also make appropriate recommendations on the proposed time-frame and measures required to complete the formation of the CU or FTA. The working party may also provide for further review of the agreement, if required. Gantz further points out that in 2006, the transparency mechanism was strengthened to provide greater oversight of RTAs to the WTO. This mechanism requires the early announcement of RTA negotiations and submission of information on the RTA.[35] To ensure compliance of an RTA with WTO law, members of an RTA will therefore have to comply with the reporting and notification requirements of Article XXIV as well as those of the mechanism.

While Article XXIV of the GATT provides the requirements for the establishment of RTAs in the form of FTAs and CUs, recourse to these forms of RTAs is not the only option available to Members. The Enabling Clause is an extension of the Provisions for the Special and Differential Treatment for Developing and Least-

32 Article XXIV (5)(c), GATT (1947). The reasonable period of time referred to in this provision should exceed 10 years only in exceptional circumstances. Where parties to an interim agreement believe that 10 years will be insufficient, they should provide the Council for Trade in Goods with a full explanation of why they need a longer period. Paragraph 3, Understanding on the Interpretation of Article XXIV of the GATT 1947.

33 Ibid at 4.

34 Article XXIV (7)(a), GATT (1947).

35 The Procedures to Implement the Transparency Mechanism on RTAs includes guidelines on: early announcement; notification of the RTA; procedures to enhance transparency; subsequent notifcat6ions and reporting; and the preparation of factual abstracts. Available at http://www.wto.org/english/tratop_e/region_e/trans_mecha_e.htm

Developed Countries.[36] Under this provision, developed countries can extend tariff and non-tariff preferences to developing or least-developed countries on a non-reciprocal basis.[37] The Enabling Clause also allows developing countries to undertake commitments and make concessions only to the extent consistent with their individual development, financial and trade needs, or their institutional and administrative capabilities. Such countries are therefore exempted from the principle of reciprocity. As a result of the one-sided commitment of developed countries, the provision is in direct contrast to the MFN principle. The Enabling Clause also allows Members to afford differential and more favourable treatment to developing countries through regional or global arrangements entered into between less-developed countries when there is a mutual reduction in tariffs.[38]

The Enabling Clause therefore provides for the conclusion of non-reciprocal RTAs between developed and developing countries as well as reciprocal RTAs among developing countries. RTAs concluded in terms of the Enabling Clause are neither subject to the requirement of covering "substantially all trade" nor do they have to be implemented within a "reasonable time" as required by Article XXIV.[39] Such RTAs are, however, subject to some limitations and will be required to facilitate and promote the trade of developing countries and not to raise barriers to or create undue difficulties for the trade of any other contracting parties; not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on an MFN basis; and shall in the case of such treatment accorded by developed contracting parties to developing countries be designed and, if necessary, modified, to respond positively to the development, financial and trade needs of developing countries.[40]

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36 Enabling Clause, available at http://www.wto.org/english/docs_e/legal_e/enabling1979_e.htm
37 Paragraph 1, 2(a) and (b) of the Enabling Clause.
38 Paragraph (2)(c) of Enabling Clause.
39 Ibid at 4.
40 Paragraph (3) Enabling Clause.

## 4. Conclusions

Despite the proliferation of RTAs and the implications for the multilateral trading system, the WTO recognizes their importance in global trade by allowing exceptions to the core principles of MFN and non-discrimination. In so doing, the WTO seeks to ensure that RTAs are not protectionist but promote greater trade. The GATT sets out the requirements that such RTAs should meet to be compliant. These requirements generally relate to internal requirements that seek to ensure that trade is created by requiring that substantially all trade is liberalized or substantial sector coverage is achieved under RTAs. In addition, recognizing the potential for RTAs to divert trade and create barriers to trade for non-RTA members, the WTO seeks to regulate this by setting external requirements on RTAs. These generally require that barriers to trade with non-members are not increased or that no additional barriers arise as a consequence of the RTA, thereby reinforcing multilateral liberalization.

Countries wishing to enter into an RTA for goods are therefore free to do so provided that they comply with the requirements set out in WTO law. Developed and developing countries are considered differently under WTO law, with greater flexibility afforded to developing countries on the options under which they may conclude an RTA and the requirements they need to fulfil. Developed countries are limited to Article XXIV of the GATT should they wish to enter into an RTA with another developed country. Such an RTA would therefore take the form of an FTA, CU or an interim arrangement leading to that. However, developing countries have recourse to either Article XXIV or the less stringent Enabling Clause for entering into an RTA—either with a developed country or another developing country.

In Africa, RECs and RTAs that have taken advantage of this flexibility include COMESA, EAC, the Central African Economic and Monetary Union (CEMAC), ECOWAS, and the West African Economic and Monetary Union (WAEMU). SADC and the Southern African Customs Union (SACU) have opted for notification under the more stringent requirements of Article XXIV of the GATT.

The compliance of an RTA with WTO law will therefore be dependent on the nature of the RTA concluded and whether or not it complies with the substantive provisions of Article XXIV of the GATT or the Enabling Clause, as may be required. The CFTA may therefore benefit from being notified under the Enabling Clause to avoid the stringent requirements of Article XXIV and provide more flexibility to African economies, while ensuring compliance with WTO law.

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