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Unleashing the Potential:

Factoring solutions for SMEs in the AfCFTA market

Key messages

- Since January 2021 following the COVID-19 pandemic, the African Continental Free Trade Area (AfCFTA) Agreement has made progress with its implementation and operational agenda and dual phases of negotiation centred, firstly, on liberalising trade in goods and services; and secondly, addressing issues of investment, competition, and intellectual property rights.
- This substantial progress requires enabling legal, regulatory, and financial conditions for SMEs and factoring to realise their intertwined potential.
- Developmental regionalism represents a heterodox approach to improving the continent's integration environment in which SMEs are empowered, factoring solutions are encouraged, and these enabling factors to take root.
- The global factoring environment is instructive for providing lessons and experiences for the challenges faced by SMEs.
- This concerns matters such as improvements in the investment climate, putting in place credit and insurance schemes, introducing green factoring products, addressing problems of fraud and cybercrime, and making use of digital technology.

Introduction

The African Continental Free Trade Area (AfCFTA) Agreement is entering a critical and strategic operational phase of realising the ambition of its establishment, related protocols, and modalities for liberalisation. Its accelerated post-COVID implementation since January 2021 will test the resolve of the 46 state parties which have ratified it in terms of their commitments and obligations. Such resolve must be resilient, unequivocal, and sincere since it constitutes the crucible for giving operational life and normative substance to the letter and spirit of the AfCFTA. That is to transform the structure of the continent's trading landscape in a manner that moves its countries and societies irrevocably down the path towards participatory and inclusive integration.

Since the AfCFTA entered into force in July 2019, this is why the phased negotiations are so important: the first relates to phasing down tariffs on goods trade and exchanging offers on services trade; and the second will focus on investment, competition, and intellectual property rights (Ismail 2021).

Against this background and in a global environment of geopolitical turbulence and instability, the Policy Brief, therefore, intends to explore how factoring could be an indispensable financing tool in contributing to Africa's structural transformation in two senses. One is to provide immediate credit finance and liquidity to the continent's large population of 44 million SMEs which could become catalytic agents of trade and economic integration; and the other is to provide some thoughts on the types of factoring solutions that could give greater impetus to improving SME participation in intra-regional and cross-border trade.

Under enabling legal, regulatory, and financial conditions, factoring could thus provide a springboard for encouraging and creating incentives for SME growth and development, especially given the levels of debt distress that they have to confront. Crucially, it could further play a formative role in promoting value-added manufacturing and services; and, in this manner, stimulate the development of regional-value chains (RVCs).

As such, RVCs will assume greater importance in the AfCFTA's trading agenda whose underlying logic is to ensure the free flow of goods, services, capital, and labour across Africa's 55 economies at very different levels of development. More specifically, as a litmus test, the AfCFTA through its implementation and operational processes as well as negotiation phases, must create a beneficial, complementary, and supportive ecosystem for the continent's 34 Least Developed Countries, its 16 Landlocked Least Developing Countries, and its six Small Island Developing States.

The importance of developmental regionalism

The AfCFTA ecosystem embodies broad systemic goals which represent the essence of a heterodox form of developmental regionalism. Consequently, while the AfCFTA is intended to promote fair trade and asymmetrical market access, stimulate productive capacity, and develop cross-border infrastructure, its underlying ethos is also to strengthen democratic governance and contribute to peace and security (UNECA 2021). In fundamental ways, the AfCFTA thus departs from the linear and sequential approach to trade liberalisation (Viner 1950).

Besides the above features, its developmental methodology includes (Ismail 2021):

- a strong organisational and institutional architecture as well as the necessary political will to drive the integration agenda;
- a clear articulation of the goals and objectives of the integration project as well as its intended benefits for all countries;
- a collective intention to provide continental public goods that are growth and welfare enhancing and which facilitate the development of infrastructure, trade, agriculture, food security, the private sector, services, and manufacturing; and
- a normative basis for a common citizenship, identity, and bonds of solidarity that are necessary for mobilising human capital and entrepreneurship.

Taken together, these features provide a context which is auspicious, conducive, and hospitable to the growth of factoring and where its financing solutions could be a harbinger for enhanced SME growth and development across a range of critical economic sectors that are consequential for the AfCFTA. International experience shows that SMEs account for 64 per cent of global factoring transactions in activities as varied as manufacturing, distribution, transportation, construction, services, utilities, IT and communications (FCI 2023).

The global factoring landscapes

It is worth briefly examining some of the characteristics that make up the global factoring market since these are useful for understanding their implications for Africa. Following the economic turbulence and disruptions caused by the COVID-19 pandemic, the factoring and receivables finance industry grew by 18.3 per cent in 2022 with an estimated value of 3659 billion, which represents an increase of 590 billion over 2021 (Mulroy 2023). However, Africa remains a marginal player in the global factoring market: the continent accounts for a mere 1.14 per cent of total volumes compared to 24.08 per cent for the Asia-Pacific, 68.29 per cent for Europe, and 3.39 per cent for South America (FCI 2023).

In view of its undoubted potential for the continent, the ambition and prospects of the AfCFTA open a new opportunity frontier for factoring and SMEs, but there are several inhibiting issues and challenges that have to be addressed if factoring is to facilitate trade and support SME growth. These include:

- enhancing knowledge and awareness of the product;
- building capacity and expertise to establish a robust and functional factoring industry for Africa;
- strengthening legal and regulatory frameworks to ensure that contracts are enforced and transactions are facilitated seamlessly;
- putting in place technical assistance programmes to encourage collaboration and networking among Africa's stakeholders by way of conferences, workshops, and industry forums; and
- leveraging technology by developing digital platforms for invoice submission, verification, and the timely processing of payment (Çetintas 2023).

To address these issues and challenges, an important intervention has been the Fund for African Private Sector Assistance (FAPA) which is a special purpose grant of US$500 000 from the African Development Bank Trust Fund, in partnership with Afreximbank and Factors Chain International (FCI) to promote factoring awareness in Africa. The grant covers advisory services for start-up and established factoring companies on legal and regulatory matters, how to better manage risk, and improve administration systems by making better use of technology. Through the grant, the FCI Academy will also offer online courses as well as an FCI-Afreximbank "Certificate of Finance in International Trade".

The grant's focus on education and awareness includes a broad category of small investors, existing finance houses, commercial banks, legislatures, central bankers, ministry officials, and regulatory bodies. However, a targeted intervention is needed for SMEs to realise the value and benefits of factoring for domestic but especially regional African markets (Afreximbank 2021). This relates to expanding the African membership of FCI to include a range of appropriately identified SMEs across Africa's eight regional communities so that they can take advantage of FCI's financial, advisory, and technical expertise. FCI currently has 43 corporate members and business entities from Africa which make up 10 per cent of its total membership (FCI 2023).

Current dynamics in the factoring industry

Globally, there is a great demand for factoring and receivables finance services for SMEs. This is primarily a function of the economic uncertainties that accompany the vagaries of post- Covid recovery which are now complicated by the geopolitical tensions of the Russia-Ukraine war. Therefore, and given its potential as a new frontier, the African market needs to locate itself as a primary African and global destination for the growth trajectory of factoring. This will involve innovative analytical, conceptual, and policy thinking in a range of dimensions such as which follow.

The investment climate

An investment climate must be created that is receptive to factoring and receivables as an investable asset class to raise debt capital outside traditional sources such as commercial banks. Alternate sources for factoring and receivables securitisation include hedge funds, sovereign wealth funds, and pension funds. These sources will go a long way to not only improving and diversifying bases of funding, but will also improve modalities of funding, assist with mitigating risk, and provide greater flexibility in cross-border transactions, all of which have great resonance and relevance for the continent's SMEs (Mulroy 2023).

Allied to investment, is how SMEs can take advantage of new developments in evolving receivable exchanges and registries as an alternative means of raising debt capital. This entails establishing electronic auction platforms where potential investors can purchase receivables. On such platforms, for example, SMEs can acquire the means and access to working capital by auctioning their invoices to African and global networks of institutional buyers through a competitive bidding process in real-time trading conditions (Mulroy 2023).

Credit and insurance schemes

In the African context, the importance of credit guarantees and insurance schemes cannot be stressed enough in underwriting the uncertainties, insecurities, and deficits of SME financing. Poor domestic institutional and governance conditions as well as the wider continental economic and political milieus have much to do with these phenomena, particularly concerning the poor levels of buyer and debtor information, political instability and conflict, difficult business and trading environments, poor government support, and bureaucratic obstacles and red tape (Beck and Cull 2014).

A major development in assisting with underwriting the needs of factoring parties has been the agreement between Afreximbank and the FCI to develop a new pan-African repository of SMEs that focuses on payment data (Mulroy 2023).

Green factoring products

In the wake of the recently concluded COP 28 agreement on climate change in the United Arab Emirates, Africa's SMEs are well placed to take advantage of green factoring products aimed at reducing environmental and social risks. This especially relates to the US$175 million allocated to the Alliance for Green Infrastructure in Africa, a commitment of US$7 billion to the Declaration on Sustainable Agriculture, Resilient Food Systems and Climate Action, and US$1 billion raised for the Declaration on Climate and Health (Olajide 2023).

In the case of China, factoring products which comply are eligible for lower-cost while those which are not face stricter domestic and international auditing requirements. Typically, green compliance standards address metrics of climate adaptation, transparency of payment, disclosing information on ownership, economic inclusiveness, and adherence to labour standards (Tang 2023). These standards could improve factoring governance for SMEs in Africa generally and green factoring in particular.

The fraud and criminal nexus

As a cautionary note it is important to be aware of the increasing proclivities for fraud in the factoring and receivables industry, where emerging markets and developing countries such as those in Africa are particularly vulnerable. The higher reliance on digital technology and artificial intelligence has increased the propensities for fraud since factors must perforce make quick decisions to provide immediate financing. Since factoring turnover in 2022 represented 12.5 per cent of Europe's GDP, the EU region has become an attractive prospect for fraud and criminality (Bresciani 2023).

In the case of China measures have been put in place such as knowing customers' history, the companies' equity structure and operating performance, which are followed by rigorous background checks (Tang 2023). Some Latin American countries such as Colombia, Mexico, Peru, and Chile have adopted electronic invoicing (Sanchez 2023). In Africa's case, a “back to basics” approach is needed with a focus on training, sharing of knowledge, and better due diligence and internal governance such as ensuring a judicious division between sales, risks, and operations (Ernest 2023).

Mitigating risk

The 'stress test' of post-Covid economic recovery and the energy and food insecurity caused by the Russia-Ukraine war have had a combined impact on the credit appetite of developing countries and Africa is no exception. In the case of Latin America, nearshoring has been a new business strategy for cross-border receivables and invoice financing because of countries' geographic proximity to the United States, resulting in an exponential investment boost through restructured supply chains and networks of vendors (Sanchez 2023). This form of reverse factoring has had positive knock-on effects for diversifying RVCs, a lesson which certainly should resonate in Africa (with its small domestic markets) as far as demographic, cost, and logistics factors are concerned, on the one hand; and mitigating delivery risks and disruptive bottlenecks on the other.

In addition, traditional mechanisms of risk management retain their relevance. For factoring purposes, this includes verifying invoices, ensuring adequate notifications, reconciliation, and collection. In adopting more stringent risk management approaches, new digital and advanced technologies can play a helpful role in credit risk analysis and management provided that there are safeguards against cybercrime and other systemic risks. In Europe, use is made of a Risk Appetite Framework that goes beyond credit and political considerations by generating diagnostic assessments of industry trends, consumer and business confidence, and possible supply chain disruptions (Bresciani 2023).

Digitalisation and technology

In view of the above, global experiences have shown how digital transformation can play a catalytic role in thinking about how new business models can improve SME business operations, add value to their products and services, and generate greater revenue (Radu 2023). Importantly, the use of digital technology in Africa could stimulate increased mobility, cross-border trade, and enhance the interconnectedness with other national and regional SMEs in the letter and spirit of the AfCFTA, and with it, create opportunities for digitally-driven economic growth (African Union 2020). SMEs could be the key beneficiaries of the AfCFTA's digital ethos and philosophy if properly managed, designed, and promoted.

Across Sub-Sahara Africa, there has been an upsurge in digital initiatives because of improved mobile telecommunication infrastructure, internet-driven mobile broadband networks, and the phenomenal increase in mobile phone ownership. These developments have vastly improved the operating environment for SMEs across a broad activity spectrum which includes the use of information and communication technologies; computer and mobile technologies, and applications such as e-mail; electronic commerce websites; cloud computing; electronic payment systems; and social media platforms (Achieng and Malatji 2022). The digital age therefore represents a new developmental threshold for SMEs and can be instrumental in helping to contribute to a more stable and productive business environment for SMEs.

However, the benefits that come with the transformative potential of technology and how it can assist with building SME resilience are often offset by obstacles. Indeed, the road to digital sovereignty for the continent is one fraught with high internet costs for SMEs, low digital literacy, restrictive laws and regulations regarding equal access, problems of data privacy and data leaks, and increasing incidences of cybercrime.

Policy Considerations

There are four dimensions which arise from this analytical tour that have implications for policy:

- ***The incentives dimension:*** The productivity enhancements, welfare gains, and beneficial financial linkages between SMEs and factoring could play a critical role in attracting investment, accelerating economic growth, and supporting job creation and entrepreneurship under the AfCFTA. However, a much more attractive enabling and business environment is necessary to obviate the financing burdens which SMEs have to face, as well as the disproportionate regulatory burdens and competition failures compared to larger business entities. A range of demand and supply interventions are required to lower the cost for SMEs doing business, and hence, factoring does open up more compelling opportunities for SMEs in both domestic and regional markets. Such interventions could be greatly facilitated and enhanced by shaping a new but flexible incentives landscape in Africa which could be sector specific or cross cutting; and consist of tax benefits and allowances, subsidies, concessional funding, and preferential infrastructure and technology access.

  The ACBF, Afreximbank's Factoring Unit, the AfCFTA secretariat, the African Development Bank's (AfDB) secretariat for Making Finance Work in Africa, and the Africa Finance Corporation should constitute a task force which examines how funding instruments for incentives could be integrated into the AfCFTA's SME Financing Facility, and components of its Adjustment Fund. Such instruments should be specifically designed to mitigate risk, encourage SMEs and financial institutions to adopt factoring mechanisms, and support and better institutionalise its continent-wide growth and expansion.

- ***The training and education dimension:*** While the FAPA grant is a significant contribution to raising awareness and enhancing knowledge about factoring, there is now an abiding imperative to develop a wider programme of technical assistance and education about the inherent benefits and value-addition of factoring, specifically targeted at Africa's SMEs. This will involve a coherent approach to developing institutional, systemic, and continental forms of capacity building and professional expertise. The ACBF in conjunction with Afreximbank's Factoring Unit, the AfDB's secretariat for Making Finance Work in Africa, the FCI secretariat, the AfCFTA secretariat, and with the support of the Africa Finance Corporation, the World Bank and IMF should explore the establishment of a 'Factoring Training and Education Fund for Africa SMEs' that expands the parameters of the FAPA grant for training and education. This expansion should focus on contracting the FCI Academy to customise and adapt its three courses to suit Africa's SMEs and business conditions, namely, its Introduction to Factoring and Receivables Finance; Fundamentals on Domestic and International Factoring; and Supply Chain Finance and Reverse Factoring.

- ***The green factoring dimension:*** There are several financing portals which can be opened for SMEs and factoring as African countries, regional economic communities and continental institutions pursue strategies for enhancing the continent's transition to a green energy and decarbonised future. This takes on added urgency in view of the continent's vulnerabilities to drought, rising temperatures, land degradation, flooding, desertification, changing rainfall patterns, and food and energy insecurity. As a collective, African countries have committed themselves to net-zero emissions and a pledge to mobilise US$10 billion in private capital towards a just and equitable energy transition. In this regard, Afreximbank's Factoring Unit, the AfDB's secretariat for Making Finance Work in Africa, the AfCFTA secretariat, and the Africa Finance Corporation with the support of and in partnership with the ACBF, FCI, UNECA, the UNDP, the World Bank and IMF should conduct a comprehensive econometric assessment to examine how different funding mechanisms flowing from the COP 28 process can be used to promote green factoring and SME participation and how these funds can be accessed for this purpose.
- ***The international experience dimension:*** A previous Policy Brief suggested that an AfCFTA guide with a continental reach be developed for SMEs along similar lines to the one produced for the ECOWAS by the UNDP/ECOWAS (2021). Given the embryonic stage of factoring in Africa, an accessible factoring guide in the relevant AU languages of English, French, and Arabic would prove its value as an additional educational and information tool for SMEs. This guide should draw on the rich vein of international experiences and current dynamics in the factoring industry which have been referred to and how these can be turned into learning and pedagogic tools for SMEs. The ACBF, Afreximbank's Factoring Unit, in conjunction with the FCI Regional Manager for Africa and its Education Director should examine ways and means of piloting such a guide through appropriate survey instruments, with the ultimate aim of producing a specially tailored 'Factoring Guide for Africa's SMEs'.

Conclusion

There is now encouraging momentum for accelerating the different components that make up the AfCFTA. The implementation and operational programme and the modalities of negotiations have set in motion a new and historic period in Africa's integration process. Grounded in the philosophy of Agenda 2063's 'The Africa We Want', this is a period that could unleash the untapped potential of Africa's SME to make an indelible mark on the transformation of the continent's economic and trading landscape. This potential could be significantly enhanced if factoring could be streamlined in Africa's financing anatomy as an indispensable tool for providing solutions to SMEs' enduring dilemmas and challenges of raising debt capital.

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