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Improving SME Access to Trade Credit and Financing in MENA[1]

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Small and medium enterprises (SMEs) in Middle East and North Africa (MENA), especially female entrepreneurs, face steep challenges in accessing finance and credit. This situation is now even more dire with the Covid-19 crisis.

SMEs finance their activities in three main ways: (i) shareholder funds from family, business partners, and investors (ii) payment facilities from suppliers and pre-payments from clients, known as inter-firm trade credit (in short "trade credit"), and (iii) credit facilities from banks and other financial institutions, of which a large chunk is for working capital. All these sources of funds are required for SMEs to conduct their activities in a financially sustainable manner.

The focus of this quick note is on the latter aspects: SME access to inter-firm trade credit and bank facilities to finance trade. These have major implications for financial inclusion, private sector development, value chains, and ultimately, on employment and growth. IFC is already very active in this segment, notably in poorer and fragile countries with the support of the IDA Private Sector Window, but more can be done by the World Bank. The financing of trade and value chains also needs to be much better understood by policymakers in our MENA client countries.

Access to Trade Credit

Before diving into the public policy aspects of SME access to trade credit in MENA countries, it is useful to keep in mind a few definitions and orders of magnitude.

Trade credit is simply the deferred payment facilities that suppliers (sellers) grant to their customers (buyers) to settle invoices in their sales of goods or services. Trade credit is reflected in the accounts of sellers as trade receivables (measured as days of annual sales revenues[2]) and in the accounts of buyers as trade payables (measured as days of annual costs of sales). The trade credit balance is the difference between the trade receivables and the trade payables, measured in days of annual sales revenues.

Both cross-border and domestic trade give rise to trade credit. Most global trade involves open trade credit (as opposed to trade payments secured by letters of credit issued by banks). The total volume of domestic trade is typically a multiple of GDP. In a mature economy like France, domestic trade, as measured by the aggregate sales of firms, is around 2.3 times GDP. Not all countries track trade credit, but its volume is very large. In France for example, total inter-firm trade credit exceeds 50% of GDP.

In the MENA region, few countries systematically monitor and publish information on inter-firm trade credit. In Morocco, the central bank of Morocco has conducted annual surveys of payment delays since 2010, and in 2018 established an Observatory of Payment Delays. Extrapolating from a sample of 70,000 firms surveyed, the volume of inter-firm credit in Morocco could be estimated at over 40% of GDP. This is comparable to the total banking sector credit (45% of GDP) extended to non-financial enterprises.

Central bank data show that larger firms (with stronger market power) disproportionately benefit from favorable payment conditions for both sales and purchases, while MSMEs are squeezed. During the last decade, the number of insolvencies in Morocco has tripled, and surpassed 8,000 in 2017 (of which over 7,000 ended in liquidation). Insolvencies occur mostly in the retail trade, real estate and construction sectors. About 40% of insolvencies are related to client payment delays or defaults, including late payment in public procurement contracts. A pre-Covid survey conducted by the

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[2] Trade receivables (in days) = receivables outstanding at the end of the fiscal year, multiplied by 365 days, and divided by annual sales revenues generated during the fiscal year.

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Casablanca Regional Investment Center identified access to market as a major business challenge, faced by 71% of MSMEs, ahead of access to finance. Slow payment from clients seems to be the key factor (identified as such by 45% of respondents) hindering access to market.

Other countries in MENA are taking measures to improve the collection and analysis of such data, with the support of the World Bank. In Tunisia, sample surveys pointed to a severe deterioration in payment terms even before the Covid-19 crisis. In particular, state-owned enterprises (SOEs) pay slowly due to their tight cashflow situation, red tape, and inefficient payment methods. This has a negative ripple effect on value chains and hit SME the hardest, ultimately harming investment, employment, and business growth.

Trade credit is a very simple and flexible form of financing. It is essential for SMEs and generally contributes to the efficiency and competitiveness of value chains. However, it exposes sellers to credit risks on buyers. This risk can be covered by trade credit insurance.

Access to Trade Credit Insurance

Trade credit insurance covers sellers against the risk that buyers might fail to pay on time for the goods or services delivered to them. Trade credit insurance first arose in Western Europe towards the end of the 19th century, initially as a private business, and later as a policy tool in the wake of the first and second world wars. In the 1990s, trade credit insurance became a global industry dominated by a mix of privately-owned global players, state agencies (with the largest based in China, Korea and Japan) and specialist institutions such as Lloyd's in London.

In 2019, total insured trade flows were estimated at nearly USD 6 trillion or 7% of world GDP. In more advanced markets (Europe, South Africa), insured trade flows are typically around 15% of GDP. Globally, approximately half of insured trade flows are domestic, and half cross-border. Overall, trade credit insurance underpins 15% of world exports (and up to 20% for major exporting countries such as China or Korea). Market penetration varies across geographies (highest in Europe and East Asia) and sectors (higher for manufactured goods and agroindustry exports, lower for hydrocarbons and minerals, seldom used in intra-group trade except to cover political risk). Historically, trade credit insurance has been a significant enabling factor for trade integration in Europe.

For firms, and especially for SMEs, trade credit insurance has positive externalities and brings benefits beyond pure risk mitigation:

(i) it supports financial inclusion, given that receivables backed by credit insurance may be used by sellers to raise finance without pledging cash or fixed assets to their banks, through trade finance mechanisms such as bills discounting (where a bank advances to the seller the net present value of invoices before they are due for payment by the buyer) or invoice factoring (where a seller sells invoices receivable to a factoring company or a bank).

(ii) it strengthens the balance sheet (on average, trade receivables account for 40% of the total assets of a company, and payment default by large buyers is usually the single largest cause of SME insolvency),

(iii) it also facilitates the exporters' business development and sales diversification (indeed, credit opinions from credit insurers represent a major market intelligence tool).

Econometric studies have estimated the short-term multiplier effect of credit insurance on export trade at 2.3 to 3.2[3]. The long-term multiplier effect of credit insurance on export trade is higher than the short-term multiplier.

The availability of trade credit insurance varies considerably within the MENA region. Morocco has a relatively deep and competitive credit insurance market, served by two international credit insurers, plus a domestic provider partly owned by the state. About 600 firms in Morocco use trade credit insurance. Insured trade flows are estimated at around USD 7 billion annually, of which around USD 5 billion in domestic trade and USD 2 billion in export trade (notably phosphate exports). The penetration of trade credit insurance in Morocco (equivalent to 7 percent of GDP) is significantly higher than in any other MENA countries, but only represents half of the penetration rates seen in Europe or South Africa.

Beyond Morocco, trade credit insurance is burgeoning among World Bank MENA client countries.

- Tunisia ranks second, with an insured volume of around 4% of GDP – approximately half export and half domestic. The market is dominated by

[3] Van der Veer, J.K.M., 2013, "The Private Export Credit Insurance Effect on Trade" Journal of Risk and Insurance 82 (3), 601-624.

one partly state-owned player (Cotunace), reinsured by one of the three leading international credit insurers.

- Lebanon, before the current crisis, was well served by local provider in which IFC previously had an equity stake.
- Egypt, with a market penetration estimated at less than 1% of exports, probably has the largest under-tapped potential in the MENA region. Jordan authorities have identified credit insurance as a key step to enhance the competitiveness and growth of exports. The main provider, Jordan Loan Guarantee Corporation (JLGC), created in 1994, is 49% owned by the Central Bank. JLGC has been upgrading its capabilities and increased its market penetration in national exports to around 2%.
- In addition to national providers, two regional agencies provide trade credit insurance: ICIEC (a subsidiary of the Islamic Development Bank, based in Saudi Arabia), and Dhaman (based in Kuwait).

Challenges hindering the provision of trade credit insurance in MENA countries include: relatively weak credit infrastructure, in terms of credit information, especially in the informal sector (to be insurable, firms need to have acceptable governance, invoicing and accounting practices as well as claims enforcement) and the relatively small size of entrepreneurs in developing MENA countries (credit insurers tend to target firms with annual sales of at least USD 1 million). As a result, the size of national markets in developing MENA is often small to attract direct investment from international credit insurers. These smaller markets can be covered by domestic state-owned or private providers, but they also need a minimum scale of operation to cover operating cost, invest in systems, and attract quality reinsurance.

Access to Trade Finance

SME financial inclusion is problematic in the MENA region –more so than most other parts of the world. In World Bank Enterprise Surveys, 32% of firms in MENA declared that limited access to credit was a major constraint, versus 26% globally. Among MSMEs that are led by women (on average 23% of all MSMEs), 55% do not have access to credit financing, and only 4% declare being well-served by financial institutions. There are of course differences within MENA. For example, Morocco does significantly better than the regional average, but Tunisia and Egypt significantly worse. The World Bank and the IMF estimate that, although SMEs generate over 50% of private sector employment in the MENA region, they receive on average only 7% of the banks' credit facilities, with financing volumes disproportionately absorbed by the largest corporates.

SME access to finance in the MENA region mostly consists of general banking credit facilities secured by a mortgage on residential/commercial real estate ("external collateral"), typically with very high ratios of collateral to loan value: 127% in Jordan, 167% in Morocco and 251% in Tunisia. This is particularly challenging for women entrepreneurs, in view of their relatively weaker ownership of real estate assets that banks require as collateral. Mortgage loans are expensive for borrowers and reduce competition among banks – once an entrepreneur has mortgaged its real estate assets to a bank, it becomes very difficult to switch to another bank. Loan guarantee schemes may partly fill this gap by allowing beneficiary SMEs to access bank loans without the need for mortgage collateral, but the capital and scale of operation of these schemes is seldom large enough to make a significant dent in the SME loan market.

In addition to general banking facilities, entrepreneurs need access to more specialized types of finance to operate, trade and compete successfully – especially trade finance instruments, ranging from letters of credit, to bid and performance bonds, receivable discounting, inventory financing, and bank guarantees. In advanced emerging markets, banks and specialized financial institutions offer a broad range of trade finance instruments. In MENA, SMEs have very limited access to such trade finance instruments. For SME importers, local banks mostly shun clean (unsecured) credit terms when issuing import letters of credit. Instead, they usually require full cash collateral, or a mortgage. Likewise, SME exporters in MENA seldom have access to export finance.

For most SMEs in MENA, trade finance services essentially consist of basic payment remittances and documentary collections. The banks' ability and willingness to serve SMEs is further constrained by Anti-Money Laundering (AML) and Know-Your-Customer (KYC) requirements. Domestically, SMEs need trade finance to meaningfully participate in public procurement: when bidding for projects, they need to provide bid bonds, performance bonds, advance payment bonds, etc. Once awarded a public procurement contract, SMEs need to be able to discount receivables from their public sector clients.

In advanced emerging markets, SMEs can finance their receivables not only through invoice discounting (bank financing secured by secured by invoices) but also through invoice factoring (i.e. selling their invoices to so-called factoring companies). This also allows them to outsource time-intensive receivables management, thus

allowing them to cut their operating cost and to focus on core commercial and productive activities.

The global factoring market is estimated at around USD 3.5 trillion, equivalent to 4.3% of global GDP. In West Europe factoring volumes are around 15-20% of GDP. Among World Bank client countries in MENA, Morocco has factoring volumes close to world average, but this is mostly for domestic factoring. Export factoring in Morocco was only USD 200 million in 2017 – less than 1% of merchandise exports, versus a global average of 3%. Factoring is barely available in other MENA client countries (for example, volumes in Tunisia and Egypt are less than 0.5% of GDP).

Box 1: Levels of access to trade credit and finance

The degree of access that entrepreneurs, value chains or countries may have to trade credit and finance can be measured against four successive levels of development, ranging from "no access" (level 0) to "advanced access" (level 3).

Level 0 - no access. At the lowest level, firms have virtually no access to bank finance. Inter-firm trade credit is largely based on personal trust along kinship, family or patronage lines, else transactions are paid cash. This situation typically prevails for small entrepreneurs in less advanced markets.

Level 1 – basic access. Bank credit is typically not in the form of trade finance, but rather as overdrafts or other general short-term facilities extensively secured by mortgages on real estate assets. Trade credit insurance is not available. Inter-firm trade credit exposes sellers to substantial credit risk on buyers. Payment delays, notably on sales to state-owned enterprises, tend to hinder SME access to the domestic public procurement market. This would be the typical situation for SMEs in intermediate markets, or for regular corporates in less advanced markets.

Level 2 – intermediate access. Entrepreneurs can access some basic trade finance instruments, notably letters of credit for imports, albeit secured by external collateral (cash deposit or mortgage). Incipient trade credit insurance services focus on imports rather than domestic trade although imports are still often paid by letters of credit rather than open trade credit.

Level 3 – advanced access. Firms access a wide range of specialized trade finance products, both from banks (e.g. non-recourse discounting of receivables, warehouse receipt financing, etc.) and non-banks (e.g. domestic and export factoring). Receivables can be used as a borrowing base. Banks can tailor their facilities based on the trade cycle of their clients and offer transaction-specific financing instruments in addition to standard, general banking facilities. The trade credit insurance market is well developed, not only for imports but also for domestic sales and exports. This allows SME sellers to insure the risk of payment default on their domestic and export transactions.

Although this analysis has not yet been conducted systematically, countries at different levels of access probably require different types of public policy and state intervention instruments to attain the next stage of development in trade credit and finance.

Further work is needed to better measure gaps in trade credit and finance needs in World Bank MENA client countries. These gaps could be assessed against a typology outlined in Box 1 below. This typology can be used to assess access at firm, value chain or country level.

A similar analysis can be conducted at the broader level of value chains. As a pilot, the World Bank is now conducting a financial mapping of Tunisia's value chains, in cooperation with the Central Bank. Indeed, value chains can be analyzed as reverse payment chains: while goods and services flow downstream, conversely payments flow upstream from buyers to sellers. At different stages of value chains, payment timing differences between purchases and sales create cashflow deficits, which need to be financed. Value chains are financed "internally" (organically) as well as "externally". Within value chains, sellers and buyers extend credit to each other in the form of inter-firm trade credit. Cashflow deficits within value chains are also financed "externally", through trade finance and related instruments provided by banks and other financial institutions.

Public policy implications

The analysis points to clear public policy and market development implications for MENA countries. Trade credit, credit insurance and trade finance require an enabling environment - corporate governance, insolvency law, accounting systems, credit bureaus, etc. However, even in the most conducive environments, trade credit and finance are susceptible to market failures, which calls for specific state intervention to facilitate, in particular,

SME access to trade finance and credit. Policies formulated by Moroccan authorities, as well as World Bank technical assistance experience in Tunisia and Jordan, broadly point to the need for a series of interventions that can be articulated around a four-pronged action plan:

(i) Monitoring of trade credit and payment delays: giving policymakers the ability to understand the scale of issue, to spot problems earlier, and more accurately assess the impact of measures taken. The monitoring would target government procurement, SOEs, SMEs and more broadly key national value chains.

(ii) Trade credit discipline: through regulation and oversight, encourage larger enterprises to pay on time their SMEs suppliers.

(iii) Trade credit insurance: deepen national credit insurance markets (partly to cushion the impact of the Covid-19 crisis) and incentivize the downscaling of access to trade credit insurance by smaller firms; in small and nascent markets, pooled schemes could help state providers access international reinsurance on better terms.

(iv) Trade and receivable finance: foster the use of trade receivables as a borrowing base or collateral, thus expanding the availability of factoring services (through regulations, setting up registries of movable collateral, etc.) as well as export finance including pre-shipment finance, to complement general banking facilities help SMEs in export value chains raise financing for their production cycle and the procurement of inputs required for exports.

Importantly, trade finance connects with the digitalization agenda. Until now, trade finance has relied heavily on manual, paper-based processes. Among banks, back-office processes need to become paperless. This will facilitate the validation of documents and reduce unnecessary delays.

Among SMEs, the digitalization of accounts receivables and payables enables several positive developments. These include (i) accelerating and facilitating KYC/AML procedures which until now have hindered SME access to trade finance from financial institutions, (ii) facilitating the production of quick digital accounts which can help lenders assess and monitor credit risk in real time, and (iii) credit scoring methodologies and other fintech solutions allowing small entrepreneurs to access new financing products.

Finally, the potential for using e-commerce platforms to facilitate access to trade credit and finance needs to be further explored in the MENA region. Indeed, lessons can be drawn from the encouraging developments taking place in China and other parts of the world, where e-commerce giants such as Amazon and AliBaba play a growing role in SME lending. Other large players having access to MSMEs transactions and supply chain data are entering the lending realm: logistics companies interested in financing their customers thereby fueling their own business. The e-commerce revolution will widen and deepen the financing of MSMEs and supply chains.

To enhance the competitiveness of their value chains and allow SMEs to move a higher level of financial inclusion, MENA countries need better trade credit and finance. The World Bank is gearing up to more systematically address this agenda through its lending operations, incorporating the lessons it has learnt from its analytical and technical activities.

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