How to unblock the financing of small and medium size farms in Romania? Financial instruments proposal for RDP 2014-2020

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HOW TO UNBLOCK THE FINANCING OF SMALL AND MEDIUM SIZE FARMSIN ROMANIA? FINANCIAL INSTRUMENTS PROPOSAL FOR RDP 2014-2020

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Abstract: *Recent evidence shows that that over 60% of private investment contracts have been canceled due to the lack of private co-financing. Basically, a large part of the EU funds for agricultural development cannot be accessed due to the current poor access to finance of (small and medium-size) farmers. Several factors, such as guarantees of up to 150% of the loan value, low profitability, or high default risk that hinder the sector's access to the credit market, should be mitigated by state intervention. Such a measure can be included in the 2014-2020 RDP, consistent with the European Commission's recommendation to include financial instruments for supporting access to finance for farmers and agricultural associations. The analysis presented in this paper builds on the solutions proposed in a previous CRPE report focusing on microcredit, based on the existing mechanisms of the state. Firstly, it aims to support OUG 43/2013 by establishing: (1) a fund for middle-size farms for investment of up to 300,000 Euro, significantly lower than the previous ceiling of 3 mil. Euro and (2) a microcredit fund (max. 25,000 Euro), both measures coupled with an interest rate subsidy facility. Ultimately, the aim is to reduce the interest rate that farmers are facing by at least 4 percentage points. Secondly, we propose extending and improving the instruments designed for bearing part of the risk burden, through (1) a state aid scheme for reducing the cost of the guarantees for projects undertaken by young farmers and start-ups, and (2) providing 100% guarantee for young farmers that access RDP funds for agricultural investment.*

Key words: *agriculture, credit, guarantee, financial instrument, interest rate subsidy*

INTRODUCTION

Overview of Agricultural Funding

Although credit institutions have recently manifested a higher openness and willingness to finance SMEs in the agriculture and agri-food sectors, the problem of poor access to finance remains the burden to bear by most farmers in rural areas.

Many applicants for the financial aid offered by the National Rural Development Programme (RDP) are facing difficulties in procuring the private funds required by the co-financing program. In the absence of sufficient own capital, and often rejected by banks, potential applicants are constrained to abandon their development projects, thus directly affecting their income and the local economy, as well the RDP funds absorption rate.

According to recent data from the Ministry of Agriculture[1], over 60% of the contracts concluded for the private investment measures were canceled due to the lack of private co-financing. Ceilings established in the current RDP for investment measures in the food industry (Measure 123), and in agricultural businesses (measure 121) proved to be overestimated in relation to the sector's capacity to absorb these funds effectively.

Projects worth hundreds of thousands of dollars have been drafted for the allegedly "cheapest money" (EU funds), but the issue that was not taken into account was that for every euro spent from the EU, the beneficiary has to contribute with a euro, either from its own capital, or burrowed from the credit market, to which the ineligible expenses should be added. Although most of these contracts have benefited from letters of comfort from commercial banks, pointing to the promise of receiving funding for the projects, subsequently the co-financing loans were either not granted, or the credit conditions were tightened.

On the one hand, the state considers attracting young people in agriculture (hence start -ups), as well as the development of middle-sized agriculture and family farms, to be among its priorities. However, the paradox is that no specific options for offering financial support for accessing co-financing credit have been offered to them.

[1]Data supported by explanatory memorandum HG 682/04.09.2013

There is an obvious mismatch between the pace of development of this sector and the requirements of the agriculture credit system in Romania, for which there are a few explanations:

- Credit institutions place most farmers and aid recipients of the EAFRD for micro-enterprises and SMEs in the high-risk category:
  - Most of them are not able to meet the current indicators required by banks (e.g. regarding liquidity and solvency) or they cannot provide evidence of previous credit commitments;
  - Most of them do not have sufficient collaterals (banks require a minimum 110 %, sometimes reaching 150 %) for obtaining an investment loan;
- Loan management fees are too high compared to the financial means of the applicants (i.e. the income stream from production activities);
- The profitability of the sector is low, compared to higher added value sectors. The average area of farms in Romania (3.45 ha)[2] is below the economic sustainability threshold. This means that, in the first years of implementing the projects, farmers are not able to reap sufficient income for both repaying the requested loans, and supporting the production activities;
- Credit institutions lack expert staff for understanding the peculiarities and needs of agricultural credit. Moreover, there is a dire need of having access to targeted lending products that would complement the financial contribution from both National and European funds.

MATERIAL AND METHOD

Current Credit and Guarantee Facilities

In the current framework for agricultural funding, the chosen approach was to apply a credit guarantee scheme for co-financing projects through the RDP.

Thus, the fund selected by the MARD has facilitated, by means of bearing the farmer's (beneficiary of the RDP) credit risk, a switch in the focus of the banking sector towards investment in agriculture supported by European funds.

In the current RDP, two schemes for offering guarantees for private investment projects in agriculture and food industry are offered (Measure 121 - Modernization of agricultural businesses and Measure 123 – Increasing the added value of agricultural and forestry products), as well as developing SMEs in rural areas that focus on non-agricultural activities (Measure 312 – Support the creation and development of micro-enterprises and Measure 313 - Encouraging touristic activities).

The warranties offered are strictly related to the funding by the credit institution, falling within a maximum of 80 % of its value, and no more than 2.5 million Euro. Based on the annual reports of the RDP implementation, we can say that the average collateral is currently below the ceiling, which shows that the maximum eligible value of a project was too high (e.g. €2 million for modernizing the agricultural businesses – measure 121).

In addition to European funds, MARD has adopted in 2013 a national lending instrument through Ordinance 43/2013 regarding measures to develop and support family farms and farmers' access to finance.

The ordinance is introducing the concept of family farm, although we believe that the technical definition of this category is imprecise[3]. However, it is an indication that the State is concerned by the small and medium-sized farming category, considering the emphasis on a financing vehicle that was so far ignored, namely *non-bank financial institutions*.

Unfortunately, OUG 43/2013 is still not functional because it lacks the implementation procedures (no selection was made by credit institutions). Proceeding with the selection in the nearby future would allow access to credit for farmers through both types of financial intermediaries (banks and micro-credit institutions), hence meeting the explicit objective of the normative act: supporting small farmers.

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[2] Data from the 2010 Agricultural Survey

[3] The 2-50 ESU limit includes almost all farmers.

CRPE Proposal: Financial instruments for stimulating agricultural investments.

Credit and microcredit in the new RDP

The new European Framework for 2014-2020 encourages Member States to introduce support facilities for private investment in their RDPs, by coupling these support measures with financial instruments.

In the "Position of the Commission Services on the development of Partnership Agreement and programmes in ROMANIA for the period 2014-2020" document, the chapter dealing with the competitiveness of small and medium-sized enterprises, the European Commission explicitly recommends facilitating the access to microfinance, particularly in the agricultural sector, especially in the agricultural sector and targeted at young people and the people that are furthest from the labor market, as well as micro-enterprises[4].

Furthermore, the draft of the Partnership Agreement to be concluded between the Romanian Government and the European Commission states the need for using financial instruments:

"Given the current economic situation and the scarcity of public resources, financial instruments are expected to play a more important role in 2014-2020. Their introduction will allow a higher efficiency and effectiveness in using the funds. Financial instruments may be used for any kind of investment or by the beneficiaries.

Although during 2007-2013 the implementation hasn't had the expected success, Romania intends to use financial instruments in the next programming period in order to facilitate access to finance for SMEs, for innovative businesses generating added value and encourage demand for eco-innovation, as well as for using venture capital in research and development investment in order to boost start-ups and innovative spin-offs."[5]

I. Including a Credit and/or Microcredit in the new RDP

This fund should be included in the available financial allocation, under the measure that was recently announced by MARD, from the 2014-2020 RDP, "Investment in physical assets", for which an allocation of 1832 million Euro was estimated. This measure is aiming at "modernizing farms (orchards, other investments)", "processing" and "adaptive infrastructure". This amount should be large enough to also include credit facilities for the investment projects that are targeted by the measure.

The credit and/ or micro-credit fund should be setup around clear, precise and measurable goals that correspond to real needs of support, for the restructuring of small and medium-sized farms (which are economically active and have expertise in relation to the project objective) into farms that are economically viable and suited to market requirements.

The proposal will support and complement the MARD initiative manifested by OUG 43/2013. Through our proposal, the Romanian state may decide to continue this effort (currently supported from national money) by means of also attracting European funds, starting from 2014, using the financial instruments form the RDP.

What should the financial instrument include?

a. Credit fund for developing existing medium-sized farms – loans up to 300.000 Euro, covering private co-financing, maximum of 50 % and some of the not eligible costs associated with the investment project).

We estimated the ceiling by analyzing the average value of the projects contracted under the current RDP. For example, in the year 2012 - the latest report published by MARD, the average public value of the projects contracted by APDRP were: measure 121, livestock sector - 627.925 Euro /

[4]"Position of the Commission Services on the development of Partnership Agreement and programmes in ROMANIA for the period 2014-2020"

[5] European Funds Ministry document regarding funding opportunities for 2014-2020 in order to provide a better business environment (Partnership Agreement with Romania for 2014-2020)

project, measure 121, the vegetable sector - 200.693 euro / project; measure 123 -930800 EUR / project, measure 123, the agricultural sector - 604.071 euro / project.

b. **Microcredit fund** (max. 25,000 Euro) for young farmers who want to start an agricultural business, as well as for farm restructuring activities undertaken by small farms.

In both cases, the minimum lending criteria are:

1. Maximum credit period of seven years, maximum repayment period of 10 years.
2. Credits will be offered preferably in lei, only for investment projects under the RDP, and not for working capital.
3. The maximum value of investment projects through the RDP will be 600,000 Euro for the development of existing farms and 50,000 Euro for investment projects targeted at young people who set up farms (start-ups) and for restructuring projects for agricultural activities undertaken by small farms.

The financial instrument regarding setting up a credit fund for agricultural investment projects financed by the RDP could be configured using a simpler format, predefined in the technical sheet, knowing from the very beginning the funding conditions of the grant percentage ceiling.

This requires introducing the possibility of deducting the interest rate subsidies from the grant proportion (maximum 50 %). The proportion of the subsidy will be set on the basis of the ex-ante analysis conducted by MARD for selecting the financial instruments to be included in the new RDP. The proportion of the interest rate subsidy will be decided for the entire credit period and it will be invariable.

The lending instrument is accompanied by a grant interest rate subsidy on the fund performed.

A similar methodology, approved by the Commission, has been implemented in Lithuania through the 2007-2013 RDP. The interest rate subsidy rate on loans financed from the RDP was calculated by applying a model based on the six months (VILIBOR) average interest rate for loans, denominated in the national currency, as presented by the Central Bank. Bank margin was not higher than 3 %, and the credit fee was 0.5% of the loan amount.

Our proposal makes the interest rate on loans depend on the NBR average interest rate for loans denominated in the national currency. The situation in which the money from this scheme would depend on the interest rate applied by other banking institutions should be avoided.

Sample calculation for Romania

Currently, the interest rate on loans in lei for agriculture is somewhere from 10% -12% (there are banks that practice even higher interest rates when the beneficiaries are start-ups). Currently, the six-month Robor rate for loans denominated in lei set by the Central Bank 4%. If we apply the calculation model used by Lithuania in their 2007-2013 RDP, we get the following result:

4% – (4% x 4) + 3% = 4% – 0.16% + 3%=6.84%.

This reduces the interest rate for loans in the sector from 11% - 12% to about 6.84 % (interest paid by farmers), out of which 4.16% is supported by the RDP. Hypothetically, for a credit of approx. 1,300,000 lei (about 300,000 euro):

- market interest would be 143,000 lei (11%)
- out of which 54,080 lei is paid as interest rate subsidy from the RDP, whereas the beneficiary pays 88,920 lei.

Granting credit through micro-credit institutions (NBFI) means higher operational costs[6], making the NBFI margin higher than the bank margin (as shown in the previous example). In this respect, it is necessary to consider the average level of these costs and the methodology should include different margins, depending on the financial vehicle under consideration - bank or

[6] "Financing solutions out of EU funds for small farmers in Romania: Micro-credits and guarantees", CRPE Policy Brief No. 20, May 2013

microfinance institution. However, the interest rate paid by the beneficiary should be the same in both cases.

In order to simplify the implementation procedure of this support facility, such a methodology should be included in the RDP from the beginning. This way, the potential grant recipients will know the level of non-refundable grants that could be accessed. Considering that the percentage of non-refundable grants is lower than the usual, it should be noted that the cumulative amount of aid must not exceed the maximum, amounting to 50% for public co-financing, or the ceiling value.

This option allows one to submit proposals on priorities established for this measure and the credit facility represents a powerful vector for directing funds according to the set pattern. Furthermore, it could solve the main problem faced by national authorities, as well as by the beneficiaries of the current program: namely the delay in project implementation, cancellation towards the end of the programming period and, hence, a low absorption rate of EU funds.

For an effective and efficient operation of such a scheme, and given the current RDP experience, the maximum eligible amount of a project should be reduced compared to the 2007-2013 period, and financial support for private investment projects, namely financial allocations set for the 2014-2020 RDP are to be expressed in national currency instead of Euro. There are several examples supporting such a proposal: the potential beneficiaries of investment in the agricultural sector are mainly focused on the local and national markets, rather than the foreign markets, so foreign currency receipts are not the issue. Exchange rate fluctuations are an important factor. They have to buy foreign currency to pay the rates, which induces an additional cost. Furthermore, in the process of simplifying the implementation of the new RDP supported by MARD, using the national currency for expressing the financial support under the RDP, and also in the procedures for the selection and contracting of APDRP would lead to a significant simplification much awaited by the applicants. Currently, under a financing agreement signed by a beneficiary with APDRP a level of Euro / leu exchange rate is used upon selection of the project, another one upon signing the contract and yet another one at the time of authorization of payment applications related to the project. Within the application for funding for an investment project it is provided a budget line called "differences in foreign exchange rates", amounting to 5 % of the project and it is provided in the budget of an investment project. This is used by the recipient only at the end of the project implementation, based on well-grounded claims, and only with the approval of APDRP. Usually, these funds are locked in contracts between beneficiaries and APRDP and in the end they are not asked for by the customers. In conclusion, 5% out of the public allocation for investment in farm modernization stays locked in the budgets of the contracted projects and cannot be used optimally and efficiently for contracting and building of new projects.

In order to make the support package offered through the credit and microcredit fund more effective and accessible to applicants, we recommend the introduction in the RDP of a measure offering consultancy for the applicants to this credit/microcredit facility, whose support actions are targeted on specific consultancy activities, tailored to the farmer’s needs. For example, in case a young farmer wishes to access an investment project, the project's economic and financial preparation can be carried out using funds from this provision.

We recommend two essential components:

1. An economic and financial component necessary for using RDP funds for private investment.
2. A technical component, specific to agricultural activities related to farm management.

II. Decrease of the guarantees costs for projects undertaken by young farmers and by start- ups that develop investment projects.

Providing 100% guarantee for young farmers accessing RDP investment funds

For start-ups, the guarantee fee is high (1.25 %) compared to the possibilities of access to finance for young farmers (start-ups). Therefore, it is desirable to institute state aid scheme, consistent with the European framework, for building the confidence of banks and non-bank financial institutions in the capacity of the agricultural start-ups of accessing finance and financial instruments. Under this facility, the minimis aid is in the form of a collateral.

This can be achieved by establishing a minimis scheme by taking a portion of the risk incurred by guarantee funds upon providing guarantees for SMEs in the agricultural sector. Currently, the amount of minimis aid cannot exceed EUR 7,500 for three fiscal years. Such a scheme may be established by MARD for small farms and young farmers (start -ups) in order to improve access to the EU funds.

The main reasons are related to the high cost of the guarantee fees currently charged by the guarantee fund for investment projects (start-ups), which amounts to 1.25 % of the guarantee. In addition to these costs, the start-ups must demonstrate the availability of funding amounting to a minimum of the interest due for the first year. **Furthermore, to increase the impact of the credit fund and/or micro-credit on young farmers we recommend a 100% guarantee (based on two guarantee schemes, one established by RDP funds whose coverage level to be within 80 % and another one through state budget funds, the level of which will be a maximum of 20%). To reinforce each other, the two schemes should operate in parallel and be available to ensure investment projects made by young farmers using funds from the 2014-2020 RDP.**

What is the target market of our proposal?

The proposals are addressing the categories of beneficiaries of the private investment measures of the 2014-2020 RDP as follows:

1. **Young farmers** with legal status in accordance with the national legislation. The program must include the definition of young farmers who have access to RDP funds;

2.**Small and medium-sized farms** with legal status in accordance with the national legislation, whose definition in terms of economic size is determined by RDP using the European methodology (provided by EUROSTAT) of farms, based on the "Standard Output" coefficient set by the European Commission for Romania;

3. Associative forms, first and second degree cooperatives, agricultural associations, producer organizations from all agricultural sectors, as defined in the national legislation.

CONCLUSIONS

Strategic Direction

The political will to improve access to capital for small and medium agriculture must be followed by concrete implementation instrument. Our proposal comes with such an instrument, hence providing a link with European funds. Being a very important project, the use of European funds for capitalization of smallholder farmers is consistent with the Common Agricultural Policy reform.

Popularization

Popularization of support schemes is required for them to have an impact. Financial instruments are used as support actions through EAFRD for the final beneficiaries of the RDP and, in this respect, it is absolutely necessary for MARD to promote these undertakings, as well as choosing the promotion activities based on the vulnerabilities of the credit market with respect to funding investment in agriculture;

Attention to preparing the implementation

Financial instruments can help to increase the efficiency and effectiveness of public resource allocation. This is why it is necessary to define them in the programming stage, considering the strong connection to the subsequent implementation process. This programming stagehas to be preceded by a preliminary stage of preparing the national legislation necessary for implementation, of preparing the documents by the beneficiary, procedures which must be defined by the paying agency, specialized training for the employees of the agency for payments, and for those of the management authority.

Multiplier effect of capitalization in agriculture

If these capitalization tools will work in the future RDP we have a chance to overcome major bottlenecks in the relationship between banking-agriculture. Currently, 60% of the contracts that are being terminated and this should be a warning for the future. The state can help to overcome this bottleneck and it can make through the realistic adoption and implementation of our proposal.

Accompanying the financial instruments with risk management tools in agriculture

The Romanian authorities have started regulating risk management measures for agricultural production activities through Pillar I of the CAP. This aspect complements the RCEP proposal.

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