# Mutual Funds and the Income Stabilization Tool in the EU: retrospect and prospects

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**Abstract**

Higher frequency and intensity of extreme weather events strengthen the need for integrated risk management. EU Regulation No. 1305/2013 allows subsidies for insurance instruments, for mutual funds compensating production losses, and for mutual funds to compensate for income losses. The EU toolkit in this respect has been largely underutilized, and an integrated EU policy for risk management has not been developed. The existing EU technical documents explaining the content and details do not provide clear explanations and interpretation of the current regulations and so more efficient guidelines for Mutual Funds and sectoral Income Stabilization Tools should be developed. This could be facilitated by establishing a platform for public consultation, knowledge sharing and learning which would include stakeholders, farmer unions' representatives and academics, to help the process of building shared experiences or even common benchmarks. The platform would be part of a dissemination and innovation effort to capitalize knowledge in a learning curve and would act as a catalyst for the implementation of MFs and ISTs.

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# Mutual Funds and the Income Stabilization Tool in the EU: retrospect and prospects

Higher frequency and intensity of extreme weather events have increased farmers' risk exposure (Mills 2005), which strengthen the need for integrated risk management. On-farm and off-farm strategies, market-based solutions and policy interventions are elements of such an integrated system to manage risks. For instance, individual savings, mutual funds (collective savings), agricultural insurance, as well as financial contracts (such as credits and derivatives), are all *ex ante* instruments for dealing with specific types of risks, from normal to catastrophic, from idiosyncratic to systemic. These are illustrated in Figure 1 (adapted from the OECD) and are part of an integrated risk management strategy. *Ex post* disaster assistance by Member States is also part of this system

*FIGURE 1 ABOUT HERE*

Some of these instruments are currently available within the EU Common Agricultural Policy, defined by articles 36 to 39 of EU Regulation No. 1305/2013. The Regulation allows subsidies for insurance instruments (art. 37); for mutual funds compensating production losses due to climatic, sanitary and environmental risks (art. 38); and for an Income Stabilization Tool (IST) which consists of mutual funds compensating income losses due to production and/or price risks (art. 39). Compensation benefits from the public financial contribution are limited to 65 % of losses, shared between the European Agricultural Guarantee Fund (75 %) and the Member States (25 %).

Among Member States (MSs), only France operates a mutual fund as regulated by Art. 38. In 2012, the *Fonds national agricole de Mutualisation Sanitaire et Environnementale* (FMSE), was created under Regulation CE 73/2009 (art. 71) and limited to adverse sanitary and environmental events, to provide a national fund that merged local mutual funds developed for livestock producers.

Only three MSs had planned expenditures for developing mutual funds under the Art. 38 within their Rural Development programmes for the period 2014-2020. France has budgeted €60 millions for the

FMSE, Italy €97 millions, and Romania €200 million. Currently, however, the FMSE is the only fund under Art.38 in the EU.

Three MSs have also planned to implement an Income Stabilization Tool (the Spanish region of Castilla et Leon, Hungary and Italy), but none had been implemented by the end of 2017. Overall, the EU toolkit proposed in the regulations has been largely underutilized (Chartier *et al.*, 2017).

It might be possible to achieve wider adoption of the toolkit in the EU, but there are significant hurdles to its implementation. The approval of the agricultural part of the 'Omnibus Regulation' (Reg. 8314/2017), approved on 13 December 2017, offers some benefits. First, it lowers the thresholds when compensation can be paid. Second, it allows sectoral Income Stabilization Tools (ISTs) and the use of indexes (instead of farm-specific values) to monitor losses (under art. 39), and grants subsidies for the start-up of Mutual Funds (MFs) (under art. 38). However, some of these provisions, like setting the thresholds below 30 %, would make them incompatible with WTO green box criteria i.e. policy interventions that are considered non-distortive for the market. This reduces the potential for making these risk management policies a significant part of the future CAP, from 2020.

**Article 38: implementation in selected Member States**

Article 38 regulates the functioning of mutual funds to compensate for losses due to 'adverse climatic events, animal and plant diseases, pest infestation and environmental incidents'. The fund creates a financial reserve through annual farmer contributions that are regulated by each fund. If adverse events lead to a production loss beyond a threshold of a 30 % (lowered to 20 % under the Omnibus regulation applicable on January 1st, 2018), the fund compensates losses according to the rules under Article 38. The production loss is compared to an average production computed with respect to the preceding three-year period, or the preceding five-years excluding the highest and lowest figure, the so called 'Olympic' average. The recipients of compensatory payments may benefit from a public financial contribution limited to a maximum 65 % (Reg. 1305/2013Annex II) of the compensation granted to farmers; this is shared between the EAGF (from 53 % to 85 % depending on the relative GDP per capita of the region, according to the art.59 of the Reg. 1305/2013) and the relevant Member States (25 %).

The rationale for mutual funds is to deal with risks that are beyond the individual farmer's capacity to cope with but are not too systemic in that the pool of farmers in the mutual fund is diverse enough to manage without bankrupting the fund. Large insurance companies would, for example, be able to manage and transfer more systemic risk to bigger pools of farmers.

France and Italy, for more than fifty years, have developed subsidised (and mandatory) mutual funds against climatic risks, respectively Fonds National de Garantie des calamités Agricoles in France (established on 10 July 1964) and Fondo di Solidarietà Nazionale in Italy (established on 25 May 1970). In the early 2000s France started to switch from a mutual fund for climatic risks (Fonds National de Garantie des Calamités Agricoles) to a private insurance system. The mutual had many limitations due to questionable mutualisation characteristics where farmers in the north effectively paid those in the south, and the grain sector paid the fruits and vegetables sector.

The situation in France differs somewhat from Italy and the Netherlands, with a history of extensive participation in the FMSE (Fonds national agricole de mutualisation du risque sanitaire et environnemental) due to the capacity of the farmers' unions to create a unified governance body, and to design a common mutual instrument with innovative organisation (a common section for the whole agricultural sector, and specialised sections). The expansion of the FMSE is now awaiting: (i) improved regulation for the threshold of loss for preventive actions for sanitary risks; and (ii) improved regulation for environmental risks to reduce legal uncertainty (Chartier *et al.*, 2017 – Case study n.4).

The second key of the management success of the FMSE in France is the close cooperation between the services of the Ministry of Agriculture and the design of the compensation process. The direct and consequential losses incurred by farmers are estimated by the Ministry of Agriculture, whereas the financial implications are managed by the FMSE (after validation by a mixed public-private Committee for Agricultural Risk Management, named Comité National de Gestion des Risques Agricoles, CNGRA). In addition, the process of managing sanitary risks by the FMSE has the potential to produce information and data that could be used to design additional insurance contracts on sanitary risks.

In Italy the Ministry of Agriculture has allocated a budget for a mutual fund to which it attaches a high priority, but some practical and administrative issues need to be solved prior to implementation. For instance, there is no agreement on the realization of a single (national) fund or several (local) funds, as well as on the necessity to realize a single-sector or multi-sector funds. Indeed, in Northern Italy several local, limited and unsubsidized funds have already emerged, based on private initiatives. While EU subsidies have the potential to help existing (private) funds to expand, and to promote the emergence of new funds, there are lessons to be learned to avoid crowding out by existing private funds.

In the Netherlands, the existing (not subsidized under art. 38) mutual funds are able to cover risks that are uninsurable in the commercial market, are eligible for the EU subsidies (under art. 38), but are not always big enough in terms of number of participating members. In particular, their small size may imply a limited financial capacity of compensation that may be avoided by carefully balancing the set of insurable risks, the size of the premiums, and the amount of savings of the funds (Meuwissen *et al.*, 2013). Similar issues have surfaced in Italy, where several private funds have started in the Northern regions.

Romania provides additional lessons concerning participation. Since 2013 it has been legal to implement MFs under art. 38 of the Reg. 1305/2013. However, no MFs have been implemented under this article, because, *inter alia,* there has been a lack of leadership in the farmers' unions, and a lack of cooperation between the Ministry of Agriculture and the farmers' unions.

Guidelines for establishing an MF under Art. 38 could be helpful, in particular if agents have limited previous experience in such matters. In order to favour the implementation of MFs, it would be helpful to develop a template for MF accreditation (an example can be found in Romania) and for the application rules, including definitions and methods of validation of indices. Such a template, at national and EU levels, should be discussed not only with representatives of farmers unions, and EU stakeholders, but also with independent experts and academics.

**Art. 39: implementation in selected MSs**

Article 39 regulates the Income Stabilisation Tools, a mutual fund that compensates for less than 70 % of income losses when the actual loss is greater than a 30 % decrease compared to a computed historical income (triennial or 'Olympic' averages). Under this provision, income is defined as '*the sum of revenues the farmer receives from the market, including any form of public support, deducting input costs*' (Regulation EU 2017/2393). The rationale for such funds is to create a financial reserve, via annual farmer contributions, to compensate farmers in case of an adverse event resulting in income losses.

In the Spanish region of Castilla et Leon, it has been difficult to create an IST. These difficulties started from the very preliminary period of designing the instrument, including the concept of an IST dedicated to specialized dairy producers (therefore a potential sectoral IST) and the practical measurement of income (Kantor 2015).

In Hungary the main focus has been on the development of a private insurance system, with a clear intent of the Ministry to implement an IST, but nothing has been implemented thus far. Again, the lack of experience within the EU and the lack of guidelines from DG-AGRI appear as the main obstacles to the development of one or several ISTs. The lack of any significant experience in other countries outside the EU makes it difficult to accept the IST as a broadly used instrument.

The Ministry of Agriculture in Italy has allocated a budget for the implementation of an IST, but no regulation has been established for supporting the functioning of the IST. The major obstacles seem to be difficulties in monitoring the historical income of farmers (due to loose accounting rules for Italian farmers), and the level of the threshold (30 %), which is claimed to be too high. The Ministry is working on the use of area/crop indices to assess input costs and revenues, through benchmarks. The solution is not fully agreed with farmers' associations that have lobbied for a larger allocation of funds for the IST.

In France, the Ministry of Agriculture has not implemented an IST due to the perception that the instruments in place sufficiently cover risks. In addition, the Ministry raised the question of potential double compensation if farmers use two instruments, for example, crop insurance and IST. The evidence on the dairy sector, which was recently deregulated, suggests that the following conditions need to be in place for the implementation of an IST: (1) sectoral mutual funds; (2) gross margin indices per unit of production rather than individual accounting revenue; and (3) 'stabilizing' tools for income variations. The latter requires adequate parameters in the gross margin index and the need for legislative improvements on technical aspects. The sugar beet sector, which was deregulated in 2017, undertook a feasibility study under the assumption of being a sector compatible with a sectoral IST: it has been concluded that IST would be an opportunity to cope with severe (and intense) risks in period of crises and to facilitate competitiveness on international markets.

The Omnibus Regulation introduces potential additional incentives allowing for sector-specific IST that may compensate losses exceeding 20 % of average annual income. In addition, the Regulation allows the subsidizing of '*administrative costs of setting up the mutual fund*' and '*the amounts paid by the mutual fund as financial compensation'.* Moreover, the use of indices for the computation of the annual loss of a farmer's income may facilitate the implementation of the IST. However, it is still uncertain how much these incentives will facilitate the development of ISTs and if they will ensure their efficiency in the management of risks.

**Concluding remarks**

Several challenges limit the application of MFs, under art. 38, and IST under art. 39 of the CAP. At the EU level, more effective and efficient guidelines are necessary. The existing technical documents explaining the content and details of art. 38 do not provide clear explanations and interpretation of the current regulations. It would, in fact, be beneficial to start with the usual ‘Frequently Asked Questions’ derived from the working groups that are regularly organized by the DG-AGRI. The development of these instruments could benefit from an EU level ‘learning curve’ on the existing use of mutual funds in order to promote their development among MS.

As for art. 39, it seems crucial to define and to allow sectoral ISTs in order to group farmers who are facing the same type of risks and are thus willing to participate in the fund. It would be desirable to move towards the use of indexed income (such as gross margins) as a proxy for farmer’s income, and to calibrate the threshold of loss from an actuarial model supported by a standard formula. In addition, the guidelines could provide indications from actuarial models that are replicable for different types of production (and sectors) in different Member States. This would stimulate competition across countries and contribute to stabilizing gross margins for the entire EU area.

The creation of a platform for public consultation, knowledge sharing, and learning that includes stakeholders, farmer unions’ representatives, and academics, may help the process of building common benchmarks for MFs and IST. In particular, the consultation with experts may prove effective: (a) to exchange international, national and local experiences on funds; (b) to learn how to organize and implement them in a sustainable and efficient manner; and (c) how to write regulations with efficacy and clear definitions, that are easy to interpret and implement in all Member States.

The platform could be part of a dissemination and innovation effort to capitalize knowledge in a learning curve and would act as a catalyst for the implementation of MFs and IST. For instance, experience on different IST rules of management could be shared to improve the capability of planning funds at the regional or company level, with mandatory or voluntary participation. Experience should also be gained from the successful development of the private insurance sector in EU Member States e.g. in Germany or in the US (Santeramo and Ramsey, 2017).

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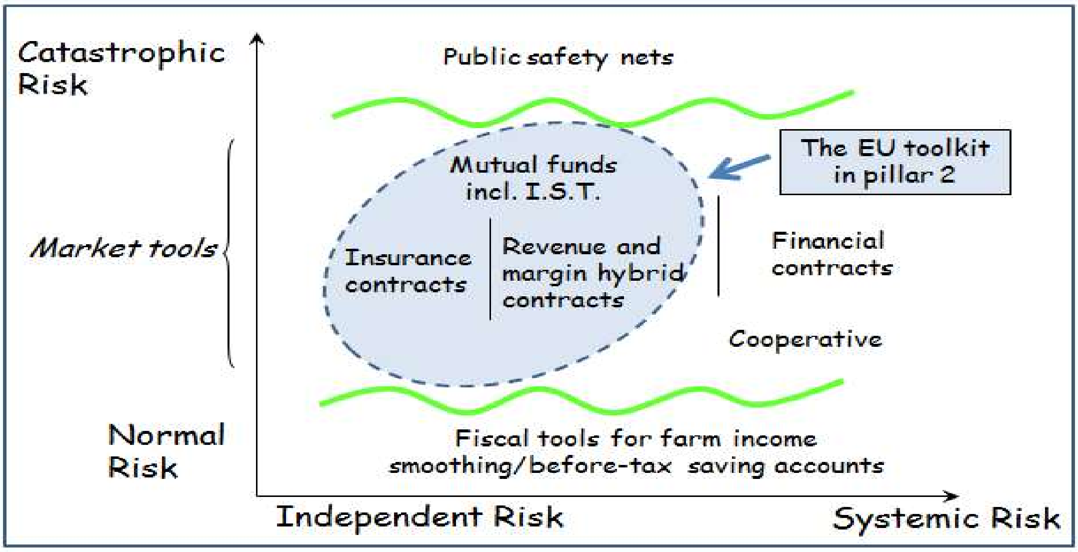
## Figures and tables

**Figure 1: Risk management instruments in the EU toolkit (CAP 2014-2020)**




*Source*: authors' adaptation from OECD (2009)