European Network for Rural Development

Draft Interim Report on the ENRD Rural Entrepreneurship Thematic Initiative: Rural Finance

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Compiled by the ENRD Contact Point

Connecting Rural Europe

1. Executive Summary

Easy access to rural financing is nowadays considered as one of the most important obstacles to the development of rural entrepreneurship in the European Union (EU). Rural development policy is addressing this issue by providing financial support to rural entrepreneurs. However, due to its incentive character the assistance delivered cannot cover the total project costs; Maximum aid intensity rates are applied to award grants to investments. This implies that project owners have either available self-funding or to obtain loans from the banking sector.

If beneficiaries have difficulties and find it hard to co-finance their EAFRD-supported investments the RDP measure(s) cannot be used.

The NRN Rural Entrepreneurship Thematic Initiative initiated work on how to overcome obstacles to rural entrepreneurship and formed a task force to investigate this particular theme.

Four main topics for elaboration by this task force were set, namely:

i) The collection of examples of actively applied financial (engineering) instruments in the EU;
ii) Training on financial engineering instruments directed to rural entrepreneurs, the financial sector and the public sector in general;
iii) Raising awareness about the possibilities for financial engineering under the EAFRD[1] and also with other EU funding.
iv) Getting a common language and a rating mechanism for rural investment proposals.

As regards the first topic, a survey was carried out in 2011, which identified examples of financial instruments designed to support rural enterprises in the EU. Six Member States (HU, LV, IT, DE, SE, FI) participated in the survey and provided details on various rural financing schemes. The survey investigated the: i) type of financing of the instrument; ii) market failure addressed; iii) type of instrument and reason for setting it up; iv) size, budget, geographical coverage and duration of existence of the instrument; v) beneficiaries and investment objectives; vi) eligibility requirements and support measures which secure viability and success.

Financing instruments identified were quite diverse in terms of their type, operational domain and approach, regulatory framework and socio-economic and institutional context. Instruments were classified into to two major categories, namely:

- Large scale, top down, initiatives based on guarantee or revolving funds supporting the traditional financial system to ease the access to finance, loans or venture capital. They can be EU-funded or nationally/regionally funded. The size of these funds ranges between € 100 – 200 Mio. Most of the regionally funded instruments have a much lower starting capital of € 1-5 Mio.
- Small scale, bottom-up, locally funded initiatives often based on self-help groups and working as an alternative or as supplement to existing financial systems. The size of these funds is generally below € 1 Mio and very often much smaller.

The main issues identified by the survey are as follows:

- Venture Capital Funds are quite popular at local level, while Guarantee Funds are popular at national level.
- The surveyed instruments seem to be addressing the specific market failures that they have been designed to cater for.

[1] European Agricultural Fund for Rural Development

- Reasons and procedures of their establishment and the way they operate vary considerably; however, they often reflect different socio-economic, institutional and developmental conditions.
- Both large-scale and smaller-scale schemes seem to promote the bridging of the rural finance gap.
- Small scale local and regional initiatives developed through endogenous, bottom-up procedures and tailoring their operations towards meeting local needs seem to be associated with a higher level of success (but at local level), compared to their larger-scale counterparts.
- Small-scale local initiatives have the capacity to be innovative in their approaches due to the fact that they are more able (compared to nationwide, larger schemes) to conceptualize local needs and identify smart and effective ways to deal with them.
- Venture Capital Funds seem to be quite successful if developed through local, endogenous initiatives, and rather scarce (at least in the EU) if centrally managed. Perhaps the fact that enterprise control remains at local level in the case of endogenously-established smaller schemes is an important factor explaining this success.

Due to the importance of the availability of financing for rural investors, a further investigation by the Rural Finance Task Force on factors determining success and viability of such initiatives and on how innovative rural finance approaches and instruments can be transferred across the EU is proposed. This investigation is specific to three priorities, namely:

- Enhancement of survey results by collection of further information on other existing rural finance instruments.
- To investigate reasons behind the exclusion of rural financing schemes from Rural Development Programmes in specific EU Member States.
- To investigate in depth the performance of existing rural financing schemes, in both EU and Non-EU Member States and identify the factors and characteristics determining their successful implementation.
- To generate knowledge on the perception of the various key financial institutions in relation to investment initiatives undertaken in rural areas.

Subsequently, the following activities are defined to accommodate this investigation:

a. Targeted collection of further information of MA's and PA's in EU Member States which have included rural finance schemes or withdrawal of such schemes in their RDPs. (Identify factors influencing uptake of financial schemes, performance of financial engineering instruments)

b. Targeted collection of further information of MA's and PA's in EU Member States which have not included rural finance schemes in their RDP's (Identify factors influencing such decisions in relation to the situation in their financial and credit markets)

c. Targeted collection of additional examples of rural finance instruments (EU/Non-EU MS) including support provided by NGO/foundations;

d. Targeted collection of information from financial institutions on the factors related to credit risk mitigation.

2. Background and Context

In the last two decades, rural areas in the European Union have been facing significant structural change, reflected by (amongst others) the diminishing economic importance of agriculture, the impacts of residential, recreational and touristic developments, and increasing environmental concerns. This development change has attracted the increased attention of rural policy-makers, and especially of the European Commission. Reforms of the CAP[2] product and producer support (Pillar 1) were accompanied by a gradual reform of EU rural development policy (Pillar 2). EU expenditure on rural development policy (RDP) measures significantly increased and attempts were made to implement these interventions in a more "integrated" framework.

Two EU Regulations have played a major role in facilitating this new RDP approach. EC Council Regulation 1257/99[3] specified an "extended" menu of rural policy measures to be implemented 'at the most appropriate geographical level'. EC Council Regulation 1698/2005[4] further reinforced EU RDP, through the introduction of a single funding and programming instrument (EAFRD), and emphasized complementarity between Pillars 1 and 2; in parallel, it specified three major intervention objectives, namely, improving competitiveness of agriculture and forestry (Axis 1), improving the environment and the countryside (Axis 2) and improving the quality of life in rural areas and encouraging diversification of economic activity (Axis 3).

The above reforms were further reinforced by the 2008 CAP Health Check[5] agreement and the European Economic Recovery Plan[6] (EERP). This policy will further evolve following the Commission communication on the "CAP towards 2020"[7], and the recent proposals on the 2014-2020 budget[8] and the post-2013 CAP legislative proposals[9], with potentially very different repercussions for both Pillar 1 and 2.

In an era of increasing market liberalisation characterised by the emergence of new products and markets and by severe competition often facilitated by technological advancement, the creation of new, competitive and innovative rural businesses and the modernisation of existing ones is arguably a key determinant of the success of efforts by policy makers to facilitate a smooth and viable "rural adjustment". This is because competitive rural enterprises are vital for rural economic growth as they play a key role in creating and maintaining rural jobs and subsequently significantly affect rural vitality.

In turn, investment in rural businesses is a rather sound precondition for their development, as it facilitates the expansion of their operations, the development of new products and the utilization of new staff and innovative production facilities and methods. In other words, it can be safely argued that nowadays, rural investment is a sine-qua-non factor for rural development in the EU (and elsewhere).

Investing in rural business relies on entrepreneurs or groups of entrepreneurs willing to take a risk, based on their perception of an opportunity combined with their judgement of their own ability to perform. In this context, the availability of financing for rural investors is an issue of paramount significance, especially if the role of innovation in raising productivity and maintaining competitiveness is taken into account. Also, it has been repeatedly argued that such a factor is particularly important for rural firms which often participate in very competitive markets, produce innovative products (in an

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[2] Common Agricultural Policy - http://ec.europa.eu/agriculture/capexplained/index_en.htm

[3] EC Council Regulation 1257/99
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1999:160:0080:0102:EN:PDF

[4] EC Council Regulation 1698/2005
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:277:0001:0040:EN:PDF

[5] CAP Health Check - http://ec.europa.eu/agriculture/healthcheck/index_en.htm

[6] European Economic Recovery Package - http://ec.europa.eu/agriculture/healthcheck/recovery-plan_en.pdf

[7] Commission Communication "CAP towards 2020" – http://ec.europa.eu/agriculture/cap-post-2013/communication/index_en.htm

[8] Proposals on 2014-2020 EU budget - http://ec.europa.eu/budget/reform/

[9] CAP 2014-2020 Legislative Proposals- http://ec.europa.eu/agriculture/cap-post-2013/legal-proposals/index_en.htm

effort to differentiate), and are also often engaged in economic activities which are sensitive to economic fluctuations (e.g. tourism; niche food products, etc.).

Despite the fact that the importance of rural financing has been widely acknowledged, it is still considered as one of the most important obstacles of rural entrepreneurship and business development. Financial "exclusion" of rural businesses (alternatively called "rural financing gap") and the limited access to capital for rural investors has been well documented in recent years. This shortcoming can be possibly attributed to both economy-wide and rural-specific factors.

At the macroeconomic front, there are currently at least 3 factors currently affecting the business community worldwide:

- monetary policies both in Europe and USA have been expansive for the last three years, following the financial crisis occurred in 2008. Interest rates have been kept "near zero" as a stimulus to the economies. However this monetary approach of most Central Banks, while supporting economic recovery, also gave way to a resurgent inflation. As a consequence the European Central Bank has already begun raising its interest rates, adopting a trend which might continue in the next 12-18 months. Increases will be decided step by step, but it cannot be excluded that in the next 2 years interest rates might grow by 200 basis points (2%), therefore doubling the level we have seen in 2009-2010;

- the higher cost of borrowing is currently affecting economic recovery, especially with defaults on bank loans being so high worldwide, with special emphasis on those sectors which have not yet benefited from it;

- bank lending could be reduced in the next 2-3 years due to the implementation of the new Basle 3 Accord con Capital Adequacy[10]. The Basle Accord is an International regulation setting out minimum capital requirement for banks worldwide, aiming at ensuring that they will not become insolvent in case of an economic downturn. The regulation is based on a fixed ratio between capital and the so called "weighted assets", which for the purposes of this report we can assimilate to just "lending".[11]

Over the next 3 years the three factors above might produce a more difficult access to finance by all firms, including rural enterprises.

In parallel, factors specific to rural conditions (further) affect negatively the access of rural investors to capital. This is because in the eyes of commercial creditors, financial support to rural enterprises is associated with a high level of risk, compared to financial support directed towards their urban counterparts. According to the international literature, this risk gap is due to factors such as lack of information (on behalf of creditors who often locate far away from rural businesses) and awareness (on behalf of investors), high uncertainty associated with the competitiveness of rural businesses, and low availability of business support mechanisms (e.g. business consultants, technical support). As a result, the range of rural finance products available is often limited and this often deters rural investment plans.

In an effort to improve conditions associated with the availability of capital for rural investment and also promote the efficient use of Pillar 2 funds the European Commission has provided (through

[10] New Basle Capital Accord - http://www.bis.org/publ/bcbsca03.pdf

[11] This fraction (in a very simplified way) can be shown as follows: Solvency Ratio = capital /lending. Originally the fixed value of this ratio was 8% (BASLE 1 Accord), later reduced and made flexible (Basle 2 Accord, ratios were as low as 5%). Now it has been raised again and banks are given a rather long period of time to implement the new limits (Basle 3). However banks feel that they need to raise their capital even more quickly than required by Basle 3 Accord, for risk management reasons, and have already set their solvency ratio targets (ranging from 7% to 9% and more) for the next 2-3 years. The amount of capital they will have to raise to reach their new targets is very large, so it is to be expected that they will pursue a mixed approach, definitely raising the numerator of the fraction (capital) but also reducing the denominator (lending).

Regulations 1698/2005 and 1974/2006[12]) Member States with the possibility to apply financial engineering actions in the form of guarantee, loan and venture capital funds. These funds are financed by the European Agricultural Fund for Rural Development (EAFRD) and can be used to provide access to credit for agricultural, food industry and other rural businesses.

Despite the fact that this instrument has been utilized[13], there are still Member States which have opted not to include financial engineering schemes in their 2007-2013 rural development programmes. In parallel, the focus of Member States has so far been on loan and guarantee funds, as no Member State have opted to set up a venture capital fund for rural businesses. In other words, without neglecting the fact that "novel" policy initiatives take time to mature, there still seems to be evidence that an investigation of current "conditions" regarding rural finance instruments in the EU could facilitate the identification of needs for future policy action which could further improve efforts to bridge the rural financing gap.

3. Activities to-date

3.1 Survey Background

Within the context of its mandate, the ENRD initiated the setup of an NRN Rural Entrepreneurship Thematic Initiative[14], launched at the 8th NRN meeting in Rome in March 2010. Subsequently, a workshop was organized at the 9th NRN meeting in Malta (July 2010).

In this workshop, it was decided to cluster potential issues related to NRN cooperation and joint action on rural entrepreneurship into four main themes, namely:

1. Tools to Support Rural Entrepreneurship;
2. Emerging Sectors for the Rural Economy;
3. Overcoming Obstacles to Entrepreneurship;
4. Social Aspects of Entrepreneurship.

As a next step, it was decided that an investigation of theme (3) "Overcoming Obstacles to Entrepreneurship" would concentrate on the investigation of access to capital by rural entrepreneurs. Within this framework, this report aims at analytically presenting activities undertaken to-date specific to this investigation, identifying issues which have so far emerged and outlining a work plan for the next steps.

During the 11th NRN meeting organized in Bad Schandau, Germany[15] (April 2011) discussions focused on the issues related to lack of credit facilities and finance to support in relation to rural development initiatives undertaken in rural areas.. The Swedish NRN took the lead and other participating NRNs included Latvia, Finland and Italy. New NRNs who have envisaged their interest in the task force are Hungary, Germany and France. Subsequently a Rural Finance Task Force (RFTF) was set up to investigate this particular theme.

Furthermore during the same workshop four main topics where identified for further elaboration by the RFTF, namely:

[12] EC Commission Regulation 1974/2005-
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:368:0015:01:EN:HTML

[13] Total expenditure under these instruments in 2007-2013 is expected to reach EUR 578 million.

[14] http://enrd.ec.europa.eu/en-rd-events-and-meetings/nrn-meetings/en/nrn-meetings_home_en.cfm

[15] http://enrd.ec.europa.eu/events-and-meetings/nrn-meetings/en/11th-nrn-meeting_en.cfm

i. The collection of examples of actively applied financial (engineering) instruments in the EU;
ii. Training on financial engineering instruments directed to rural entrepreneurs, the financial sector and the public sector;
iii. Raising awareness about the possibilities of financial engineering within the EAFRD and also with other funding.
iv. Getting a common language and a rating mechanism for rural investment proposals.

To elaborate the first topic (Collection of examples of actively applied financial instruments in the EU), a survey was carried out in late Spring - early Summer 2011, and identified examples (within EAFRD or "independent") of financial instruments designed to support rural enterprises in the EU. Six Member States (HU, LV, IT, DE, SE, FI) participated in the survey and provided details of examples of rural financing schemes.

3.2 Survey Questionnaire and Target Group

The questionnaire (the relevant template can be found in the Annex 1 of this report) was used to launch a survey aimed at highlighting the financial tools implemented in the various countries in order to enhance the access to finance for rural entrepreneurs.

The replies which were collected and the related presentations, which were given during the meeting held on June 29th in Brussels, detailed the most innovative elements of the financial instruments identified by the survey, introducing also a specific focus on managing methodologies of the funds, including EAFRD and other EU-funds as well as both national and regional funds. Indeed, dealing with this topic in the developed world implies that both the survey and the following analysis should take into account that the various financial tools have been in place for a while already, so that improvements may be found not so much in the tool itself rather in its implementation.

For example, in certain instances it is not only the sheer size of the resources made available that can make an impact on rural entrepreneurs; it is also important to reach the targeted beneficiaries and let them know about the new instrument, about relevant appraisal criteria or about any additional element that can make businesses more creditworthy and more economically viable in the eyes of a financial intermediary.

Therefore, the survey also tried to highlight if any specific financial instrument has been put in place together with an additional specialized support (such as training programs on financial issues, preparation of balance sheets and business plan presentations, automated scoring models, etc).

The survey was sent to all the National Rural Networks in the 27 Member States. Due to time constraints the answering time was short but NRNs from 6 Member States answered with 11 examples of financial engineering instruments, which are:

Country	Name of instrument	Type of instrument
HU	ACGF	Guarantee fund
LV	Guarantee fund for rural enterprises	Guarantee fund
IT	IT rural credit guarantee f (RCGF)	Guarantee fund
DE	XperCapital	Venture Capital
DE	Regionalwert AG Bürgeraktiengesellschaft	Venture Capital

SE	Virserum Invest Ltd	Venture Capital
SE	Heligholm AB	Venture Capital
SE	Flyinge Bygdebolag	Venture Capital
LV	EU credit fund for agriculture, fisheries and rural development	Credit
FI	Midinvest Management Ltd	Credit/Venture
FI	Omakylä Vuolenkoski Oy	Other

4. Survey Results and Emerging Issues

4.1 Instruments Identified

A summary presentation of the survey results (in figures and brief comments) can be found in Annex 2 of this report.

The findings of this survey dealt with issues such as: i) type of financing of the instrument; ii) market failure addressed; iii) type of instrument and reason for setting it up; iv) size, budget, geographical coverage and duration of existence of the instrument; v) beneficiaries and investment objectives; vi) eligibility requirements and support measures which secure viability and success. Finally, the survey identified examples of investment projects financed, as well as benefits and obstacles specific to each instrument.
Despite the limited number of cases surveyed, the analysis of these issues identified a wide variety of schemes, development targets, intended beneficiaries and financial tools adopted, and most of all showed the large difference between the two above described categories of schemes. For that reason, findings are presented below, separately for each one of these two major categories of rural finance schemes.

The survey revealed different types of rural financing schemes including venture capital, credit/loan (revolving) funds, and guarantee funds and provided valuable information on their characteristics and operation.

Venture capital is a private financial capital usually targeted at early-stage, high-potential, high risk businesses. A venture capital fund makes money by owning equity in the companies it invests in, which usually have a novel technology. Venture capital is attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan. In exchange for the high risk that a venture capital usually assumes by investing in smaller, it usually gets significant control over company decisions, in addition to a significant portion of the company's ownership (and value).

A **revolving credit/loan fund** is a source of money from which loans are made for multiple small business development projects. Revolving loan funds usually provide loans to small businesses which do not qualify for traditional financial services or are otherwise viewed as being high risk. Borrowers tend to be small producers of goods and services, farmers, and women who have no credit history or access to other types of loans from financial institutions. Organizations that offer revolving loan fund lending aim to help new project or business owners in become financially independent and eventually to become eligible for loans from commercial banks. The fund gets its name from the revolving aspect of loan repayment, where the central fund is replenished as individual projects pay back their loans, creating the opportunity to issue other loans to new projects.

Guarantee funds are used to provide financial guarantees for credits taken by investors and eases access to funding from banks. The guarantee fund deposits an amount that is used by the bank as collateral for the credit taken by the investor. Once the credit is paid back, the guarantee is released.

Financing instruments identified by the survey were quite diverse, in terms of their operation domain and approach, regulatory framework and socio-economic and institutional context. In principle, this diversity can be associated to four distinct contexts, namely:

a) Local/Regional, geographically-focused rural financing schemes (4 cases) **vs** Large-scale, nationwide financing schemes (7 cases).
b) Financing schemes in line with EAFRD or other EU funds (4 cases) **vs** Commercial - Market structures (7 cases).
c) Financing schemes activated centrally (8 cases) **vs** schemes operating in regional Rural Development Programmes with rural development programming contexts (3 cases).
d) Financing schemes operating in less-developed rural areas characterised by economic and social decline (3 cases) **vs** schemes operating in more prosperous and vibrant rural areas (8 cases).

In a more synthetic manner, investigated instruments can be possibly classified into two main categories, which mostly reflect different approaches to fostering rural finance:

- on one side lie grass root, self-help, geographically focused and financially limited interventions, whose aim seems to be the promotion of a bottom up economic development in the rural areas, mostly based on the mobilization of local resources, to be predominantly kept in the target area and used for the benefit of the local population; nevertheless both the Finnish and the Swedish presentations showed local groups striving also to attract new settlers and businesses. In the Swedish case there was also an aim to attract external capital, linking the instrument to the formal financial structures.

- on the other side, we find relatively large scale initiatives, supported by EU funding, nationwide schemes, meant to help out the final beneficiaries of EU support (EAFRD) in their search for access to funding, via formal financial intermediaries

4.2 Emerging Issues

a) Regional / Local Small-Scale Schemes

Regional/Local finance schemes identified in the survey are:

- the Xper Capital Venture Capital in Germany (Xper - DE);
- the Regionalwert AG Bürgeraktiengesellschaft Venture Capital in Germany (RAG - DE);
- the Virserum Ltd Venture Capital in Sweden (VIRS - SE);
- the Heligholm AB Venture Capital in Sweden (HAB - SE)
- the Flyinge Bygdebolag Venture Capital in Sweden (FB - SE)
- The Midinvest Management Ltd Credit Fund/Venture Capital in Finland (MM - FI); and
- the Omakylä Vuolenkoski Ltd Village development company in Finland (OV - FI).

Without ignoring the small size of the survey sample, it seems that regional / local schemes are dominated by Venture Capital Funds.

Also, the type of financing of these funds was quite different. In the three Swedish cases capital was provided solely by stakeholders whilst in Germany, Xper was jointly financed by ERDF[16], municipalities, banks and individuals, while RAG is a regionally-financed private non-stock corporation.

Finally, in Finland MM is a regional investment fund based on institutional investors (municipalities, insurance companies, etc.) and the capital of OV is provided by members of the village cooperative.

The German and Swedish cases are active at the regional and local levels, respectively, while in Finland, MM is active at the regional level and OV at the local one.

Market failures addressed by the above case studies are (i) lack of funding within the banking system and (ii) lack of own capital.

There are differences in the reasons and procedures behind the establishment of these four schemes, as well as in the way they function.

If we take the schemes operating in Sweden, we have HAB, a scheme which was set up as a local shared stakeholder company in 2002 by local residents and people linked to this area. It rents or buys real estate or bonds for the development of businesses in the area of Storsudet. Similarly, another scheme called VIRS was set up in 2006 as a local company owned by 60 local businesses and individual stakeholders. It provides funds mainly to innovative enterprises and also offers incubator services.

A community company initiated by the Village Development Association is FB. It was established in 2006 and the majority of its shares were initially exclusively owned by the village association. FB invests in property, services and other activities that create a good environment for the inhabitants and a good ground for local enterprise development. Currently two properties already purchased, renovated and rented out for commercial purposes, there are plans to put the area on the map as a "green" area with low carbon emission, solar energy, environmentally friendly building techniques etc.

In Germany, a private non-stock corporation for enterprises and citizens of the Freiburg region was established in 2006 under the name of RAG. It collects capital from citizens and finances SME investment in the region in an effort to promote the sustainable development of the regional agri-food sector.

Another fund supporting enterprises with innovative ideas managed by an external contractor is XPER. This was founded in 2007, as a capital company in the context of the EU XperRegion pilot project. It offers silent partners interests in regional enterprises.

In Finland, MM is a private equity investor founded in 2001. It is specialized in funding ownership arrangements for SMEs as well as growth-investment. Investments could be majority or minority ones and are normally in the form of share capital, a convertible or capital loan, or both. MM follows International Private Equity and Venture Capital Valuation Guidelines (IPEVG) to value portfolio companies. OV is a local cooperative set up in 2000 in the small village of Ramkvilla by 70 individuals providing EUR 45 each. This scheme has some unique features. The Municipality sold the land at below market prices to a local development company whose mission was to foster economic growth and stimulate the settling down of new inhabitants and firms in the area. To do so, it was allowed to sell land at market prices and to allocate the revenues to a venture capital fund (i.e. OV), which in turn will finance local investments. A small percentage of the revenue was paid back to the municipality. One interesting feature of this initiative is that the local development company was formed by local people and companies in the area together with people having summer houses there.

The size of the above schemes varies considerably ranging from EUR 100 million for MM in Finland to EUR 160 000 for HAB in Sweden and much less for OV.

[16] ERDF - http://ec.europa.eu/regional_policy/thefunds/regional/index_en.cfm

In all seven cases, beneficiaries are rural small and medium-sized entrepreneurs in agriculture and other rural sectors. However, Xper specializes in supporting enterprises which develop project initiatives that are more focused and in line with regional development priorities in Germany.

Finally, interviewees argued that the schemes have been successful in terms of responding to local needs and bridging the rural finance gap.

b) National Large-Scale Schemes

National finance schemes identified in the survey include:

- the Agricultural Credit Guarantee Fund in Hungary (ACGF - HU);
- the Guarantee Fund for Rural Enterprises in Latvia (GFRE - LV);
- the EU Credit Fund for Agriculture, Rural and Fisheries Development in Latvia (CFARF – LV); and
- the Rural Credit First Call Guarantee Scheme in Italy (FCGS - IT).

The type of financing of these funds was quite different. The ACCF – HU and the GFRE – LV are financed from the national budget, while CFARF – LV and FCGS – IT are jointly financed by both the aforementioned sources.

Market failures addressed are rather specific to the type of instrument, which in the case of national schemes seems to dominate (i.e. Guarantee Fund). The three Guarantee Funds mainly aim to address lack of collateral by potential borrowers, though respondents also indicate other "aims" such as high cost of borrowing and lack of own capital (HU) and lack of access to funding due to the small scale of rural enterprises (IT). In the case of the CFARF – LV, market failures addresses are lack of funding within the banking system and high cost of borrowing.

The survey found that there are significant differences in the reasons and procedures behind the establishment of these four schemes, as well as in the way they function.

In the Hungarian case, the ACCF was an outcome of a memorandum signed in 1991 between the government and the EU to promote credit facilities for SMEs in rural areas. Later, the ACCF developed cooperation with savings cooperatives. The ACCF guarantee is currently considered as a state aid. The scheme provides credit guarantees through banks and savings cooperatives. It undertakes between 20% and 80% of the risk, according to the request of the financial institution involved and the amount of the loan. Entrepreneurs apply for guaranteed through the banks of savings cooperatives, which then rate these applications and forwards those successful to the ACCF for approval.

In Latvia, the GFRE was established in 1997. Three institutions (Ministry of Agriculture Rural Development Fund and Banks) cooperate in this scheme. The Ministry specifies the national regulatory framework of the fund, the Rural Development Fund (GFRE Manager) releases guarantees after evaluating projects and issuing decisions on them to banks, while banks examine credit applications in cooperation with cooperates with the GFRE Manager on issues related to project collateral.

The FCGS – IT mainly addresses the difficulty that small rural enterprises traditionally face in accessing bank credit. It mainly addresses the needs of non-farm rural entrepreneurs who often possess insufficient collateral and was devised in 2006, in an effort to relax requirements specific to credit risk associated with the Basle II regulation. The FCGS grants a guarantee in connection with a bank loan. Applicants apply to banks for both loans and guarantees and their application is evaluated by the FCGS. If the borrower defaults, the FCGS immediately pays the commercial lender. The management methodology adopted aims to ensure that the Guarantee Fund operates strictly under market conditions and therefore its interventions are not classified as State Aid by the EU Commission. Thus the guarantee fee is adjusted to the credit risk of the borrower, following a rating procedure, as in a normal credit transaction. The innovative solution is that this rating methodology is made available to applicants, who can run the procedure to self-assess their own creditworthiness independently from a loan application. The benefit of this approach is two-fold: it allows for a better understanding between rural entrepreneurs and banks, but also allows entrepreneurs to use their rating grade to shop around among banks in search for the best conditions.

Finally, the EU Credit Fund for Agriculture, Rural and Fisheries Development in Latvia was established in 2010 in order to facilitate rural lending which had become very difficult after the financial crisis. The four partners cooperating in this scheme include the Ministry of Agriculture (regulatory framework), the Rural Support Service (transfers finances to the Credit Fund and controls their use; evaluates beneficiary applications as regards compliance to EU and national regulations), the Rural Development Fund (evaluates credit institutions and transfers finances to them) and Credit Institutions (Banks) which approve credit applications and report to both the Rural Development Fund and Rural Support Service. Utilising the Fund services, rural entrepreneurs can take a loan with fixed conditions for up to 15 years and subsidised interest rate. However, despite the fact that the Fund operates as an additional credit source for them, these conditions do not seem to be very popular with Latvian banks in this era of financial uncertainty, as they also have to face credit risk.

The above four schemes have a national geographical coverage; however, their size varies considerably ranging from EUR 185 million for the Hungarian Scheme to EUR 57 million for the Latvian Guarantee Scheme. Also their operational budget fluctuates from EUR 3 million (ACGF) to EUR 40 000 (CFARF).

In all four cases, beneficiaries are agricultural and rural entrepreneurs. Investment objectives are quite relevant with the RDP Regulation measures, while the satisfactory financial "health" of beneficiaries seems to be a common – most important eligibility requirement.

The Schemes seem to be using their web page, seminars and training course as means to promote their activities. Finally, both the Hungarian and Italian Schemes seem to have been very active in terms of number of projects supported, while the same cannot be perhaps argued for the two Latvian schemes.

c) Key Messages from the Investigation

The investigation of examples of regional/local small-scale and national large-scale rural finance schemes across Europe has revealed some rather interesting issues. These include the following:

- Without neglecting the small size of the sample, it seems that Venture Capital Funds are quite popular at local level, while Guarantee Funds are popular at national level.
- The surveyed instruments seem to be addressing the specific market failures that they have been designed to cater for.
- Reasons and procedures of their establishment and the way they operate vary considerably; however, they often reflect different socio-economic, institutional and developmental conditions.
- Both large-scale and smaller-scale schemes seem to promote the bridging of the rural finance gap.
- Small scale local and regional initiatives developed through endogenous, bottom-up procedures and tailoring their operations towards meeting local needs seem to be associated with a higher level of success, compared to their larger-scale counterparts.
- It is very likely that small-scale local initiatives have the capacity to be innovative in their approaches, due to the fact that they are more able (compared to nationwide larger schemes) to conceptualize local needs and identify smart and effective ways to deal with them.
- Within this context, one should not ignore the link between economic development contexts and institutional shortcomings on one hand and the ability to set up local schemes through a bottom-up approach on the other.
- Venture Capital Funds seem to be quite successful if developed through local, endogenous initiatives, and rather scarce (at least in the EU) if centrally managed. Perhaps the fact that enterprise control remains at the local level in the case of endogenously-established smaller schemes is an important factor explaining this popularity.

In conclusion, it can perhaps be argued that the two approaches described above are not necessarily alternative in nature and their implementation maybe best chosen according to the existing social and economic context in which a financing initiative is being devised. However, it is certainly worth investigating if and how flexible, innovative and successful examples identified here can be transferred across EU Member States.

5. Rationale and Objectives for Further Work

As already mentioned, in accordance to the mandate of the ENRD and in addition to information generated by the above-mentioned survey, further effort is perceived as necessary for the RFTF on the detailed investigation of rural financing schemes.

This effort will aim to carry out a more detailed investigation of additional examples of rural finance instruments in order to map the main reasons behind the development and success of innovative - successful financial instruments in rural areas. Taking into account rural development policy efforts by both the Commission and Member States, the development of such instruments is considered as a factor which can further release the potential of RDP beneficiaries and thus, facilitate the effectiveness of Pillar 2 funds.

This investigation will target the collection of further information on the current perceptions and reactions of a range of financial institutions possibly but not limited to commercial banks, micro-credit institutions, risk capital and seed fund organizations. Furthermore, collating information on what factors influence uptake of the various options of financial instruments as well as the performance of these mechanisms in relation to the specific nature and environment in which they are run.

In addition, investigation of the perception of Managing Authorities regarding the performance and viability of such financial instruments could help to identify the reasons behind the non-inclusion of rural engineering measures in the Rural Development Programmes in some Member States (also in comparison with situation where such instruments are set under the Regional Policy, i.e. ERDF), generate information on factors which determine success and viability of such initiatives, and indicate how successful and innovative rural financing approaches and instruments can be transferred across the EU.

Ultimately, it is hoped that through this investigation the relevance of rural finance in relation to the new 2014-2020 legislative proposals can be articulated through clear conclusions and recommendations and be presented to DG AGRI in the context of the discussions regarding the new implementing rules. Furthermore, Managing Authorities and Paying Agencies will benefit by having a compendium of the existing financial engineering models, how they are utilized and when. This may trigger National Authorities to include such mechanisms in the future RDP's in order to facilitate and support match funding issue.

It is therefore proposed that this effort is specific to the following activities:

Priority 1: *Enhancement of survey results by collection of further information on other existing rural finance instruments.*

This priority is cross-cutting to all four topics of the Rural Finance Task Force and it will involve:

• the collection of additional examples of running rural finance models by the EAFRD and other instruments including those developed by foundations with a special focus on innovative schemes;
• an in-depth investigation of best practice case studies of rural financing schemes.

This will provide in-depth information on the detailed operation of existing schemes and highlight their success-factors from the point of view of both financing scheme managers and beneficiaries. Ultimately, it will lead to recommendations on knowledge/experience transfer and the potential replication of these success stories and possible financial engineering models across the EU.

Priority 2: *To investigate reasons behind the exclusion of rural financing schemes from Rural Development Programmes in specific EU Member States.*

This priority is specific to topics i) and potentially specific to topics ii) and iii) of the Rural Finance Task Force. It will involve the investigation and ranking of factors leading to this "exclusion" and attempt to identify how could be this "corrected" in future RDP implementation.

Priority 3: *To investigate in depth the performance of existing rural financing schemes, in both EU and Non-EU Member States and identify the factors and characteristics determining their successful implementation.*

This priority will involve:

- an investigation of the perception of Managing Authorities (MAs) and Paying Agencies (PAs), on the performance of existing rural financing schemes;
- the reasons behind successful/innovative and less-successful experiences (leading to recommendations on how existing schemes can improve);

This will provide in-depth information on the performance of existing schemes and highlight reasons behind their success. It will lead to recommendations on knowledge and experience transfer with the potential of replicating these success stories and possible financial engineering models across the EU.

Priority 4: *To generate knowledge on the perception of the various key financial institutions in relation to investment initiatives undertaken in rural areas.*

Projects proposals in the field of rural development are many times perceived to pose an elevated credit risk for financial institutions. Thus, when it comes to provide rural lending in particular, the issue of credit risk is of greater concern because of the higher levels of perceived risks resulting from some of the characteristics tied to rural areas.

Issues related to standards of living, access to basic infrastructure services, education, insecure land tenure, price volatility, risk of weather shocks, etc. induce financial institutions to face an elevated level of credit risk. This means that risk mitigation techniques need to be put in place in order to safeguard the commercial interests of these financial institutions.

The largest challenge for expanding credit in rural areas is that few institutions are transferring credit risk to third parties. In developed countries, expansions of credit have been due in large part to the introduction and wide diffusion of risk transfer techniques (such as insurance, securitization).

Unfortunately, this is further compounded by the fact that the information required by the financial institutions to assess a project's viability is often unavailable. This usually results in the risks of a proposed rural development project being overrated and unable to absorb sufficient risk to provide comfort to commercial lenders.

The investigation of the above mentioned issues can be specific to distinct contexts identified through the survey of a range of financial institutions (commercial banks, micro-credit institutions, risk capital/seed funding organizations, etc.) Ultimately, it can lead to recommendations on how to raise awareness of the issues associated with mitigating credit risk in rural areas in order provide clear recommendations on possible short/long-term policy solutions that will support financial engineering frameworks.

6. Methodology and Next Steps (Work Plan)

Taking the above rationale into account, the following activities are being proposed for the Rural Finance Task Force:

a) Targeted collection of further information of MA's and PA's in EU Member States which have included rural finance schemes or withdrawal of such schemes in their RDPs. (Identify factors influencing uptake of financial schemes, performance of financial engineering instruments)

b) Targeted information of MA's and PA's in EU Member States which have not included rural finance schemes in their RDP's (Identify factors influencing such decisions)

c) Targeted collection of additional examples of rural finance instruments (EU/Non-EU MS) including support provided by NGO/foundations;

d) Targeted collection of information from financial institutions on the factors related to credit risk mitigation.

The exploratory surveys and research work will help to investigate and identify the factors which can improve the current RDP framework's by providing:

- Recommendations on actions that can be taken so that Member States can utilize financial engineering tools in their RDP in the future;

- Providing a set of clear conclusions and recommendations for DG AGRI in the context of the discussions regarding the new legislative proposals for the 2014-2020 programming period;
- An ENRD article showcasing the best examples of financial engineering instruments that can be adopted by MS's.

Annex 1: Survey template

Rural Entrepreneurship Initiative
Review of rural finance instruments in EU Member States

Name of the instrument

Member State

NUTS 2 and 3 coordinates (if appropriate)

Type of financing of the fund

<u>EU-financed</u>

EAFRD ☐ Non-EAFRD ☐

<u>Non-EU financed</u>

National ☐ Regional/Local ☐

Please explain further:

Market Failure addressed

☐ Lack of funding within the banking system

☐ Lack of collateral by potential borrowers

☐ High cost of borrowing

☐ Lack of own capital

☐ Lack of local knowledge to assess the investment proposal due to centralized bank systems with limited local presence.

☐ Other e.g. lack of access to funding due to the scale of rural enterprise

Please explain further:

Type of instrument

Credit (Loan) fund ☐ Guarantee fund ☐ Venture capital fund ☐ Other 'funds' ☐

Please explain further

Why was the instrument set up and how was it set up (description of the structure, partners involved)

Size of the fund (initial capital) **and measures of impact** (yearly amount of loans/guarantees issued, volume of funds conveyed, outstanding loans/guarantees, etc)

Operational budget (yearly costs in EURO for running the instrument)

Geographical coverage

Local ☐ Regional ☐ National ☐ Other ☐

Please explain further

Duration of existence

<1 year ☐ <5 years ☐ >5 years ☐

Please explain further

Beneficiaries

Example of investment objectives

Modernization, technical innovation, debt consolidation

Eligibility requirements (beneficiaries, eligible activities, etc)

Support measures to secure viability/success of investment objectives

Short summary of one or more investments/projects that have been supported through this financial instrument and contact details

Experienced benefits from the instrument so far

Experienced obstacles to solve along the way

Annex 2: Summary of the survey answers

Summary table

Country	Name and date of instrument	Type of instrument	Social goal	Financial goal	Type of intervention
HU	ACGF	Guarantee fund			
DE	XporCapital 2007	Venture Capital	Promising business ideas, Start ups	Local self contained credit circuit	local, Limited impact
DE	Regionalwert AG Bürgeraktiengesellschaft 2006	Venture Capital	Promote selfe help, Local initiative	Uncouple rural enterprises from financial mkts.	local, Limited impact
LV	Guarantee fund for rural entrepreneurs 1997	Guarantee fund	Promote market economy	Incentive to national credit system	National, Large scale, permanent
LV	EU credit fund for agri, fisheries and rural dev 2010	Credit fund	Alleviate credit crunch impact	Overcome difficult funding	National emergency
SE	Virserum Invest Ltd	Venture Capital	Add to the social sustanability in the community	Support the local business fabric	Local, small but long term effect
SE	Heligholm AB	Venture Capital	Add to the social sustanability in the community	Support the local business fabric	Local, small but long term effect
SE	Flyinge Bygdebolag	Venture Capital	Add to the social sustanability in the community	Support the local business fabric	Local, small but long term effect
IT	Italian rural credit guarantee fund (RCGF)	Guarantee fund	Promote rural economy	Incentive to national credit system	National, large scale, permanent
FI	Midinvest Management Ltd	Venture Capital	Prpmote regional economy	Support SMEs	Regional large impact
FI	Omakylä Vuolenkoski Oy	Other	Attract new entrepreneurs and inhabitants	Sell real estate, make profit to invest	Local impact

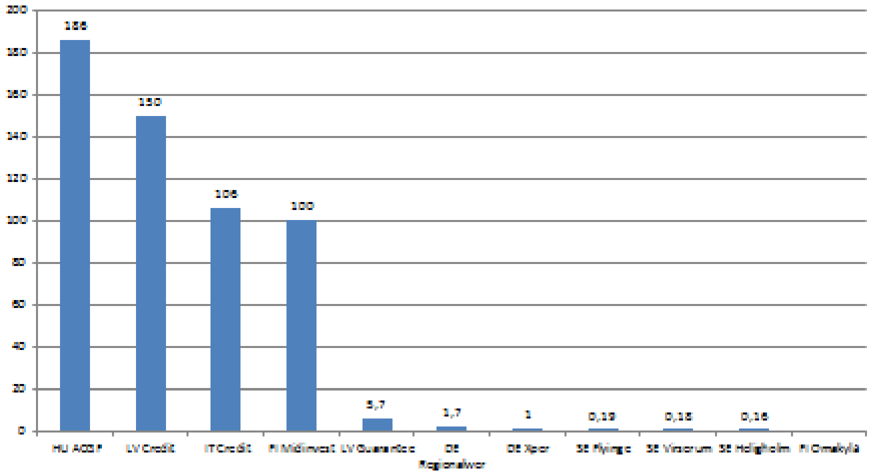
Examples of Financial Instruments

TWO TYPES OF RATIONALES:

1. Alternative to established financial markets (DE, SE..)
   - Local initiatives, self help nature
   - Limited impact, but important at local level
   - Very focused
   - Can be a long term intervention though at a small scale
2. Support to existing financial markets (IT; LV..)
   - National territory, Formal financial intermediaries involved
   - Substantial financial resources involved (see following slide)
   - Tend to be Permanent interventions

Size of the funds

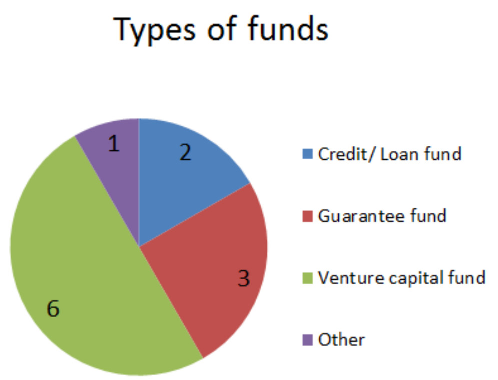
million euros

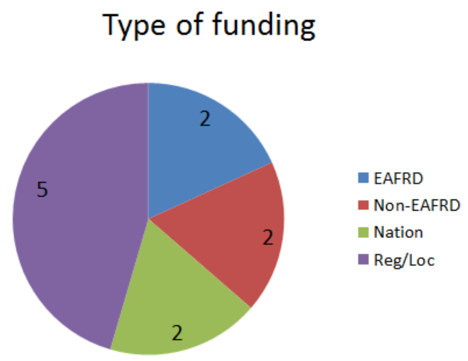


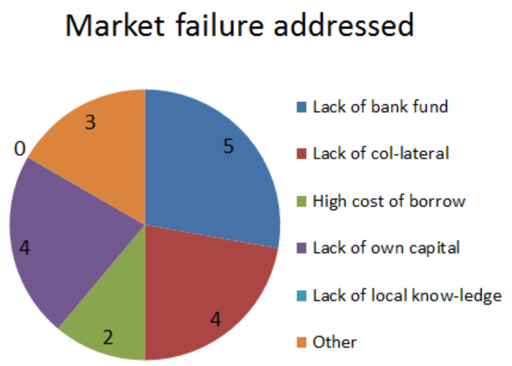
Examples of Financial Instruments

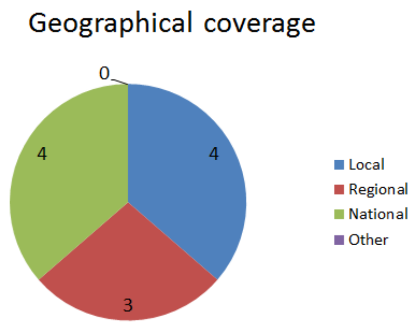
A SPECIAL FOCUS ON MANAGEMENT METHODOLOGY

- A distinctive feature in developed economies
- Use of ICT, Internet applications, electronic processing, user friendly approach etc. can improve impact and efficiency of the financial tool
- A possible task for further investigation by the TARGET GROUP?


Types of funds
1
2
3
6
Credit/ Loan fund
Guarantee fund
Venture capital fund
Other


Type of funding
2
5
2
2
EAFRD
Non-EAFRD
Nation
Reg/Loc


Market failure addressed
3
0
5
4
4
2
Lack of bank fund
Lack of col-lateral
High cost of borrow
Lack of own capital
Lack of local know-ledge
Other


Geographical coverage
0
4
4
3
Local
Regional
National
Other


Duration of existence
1
6
4
<1 year
<5 years
>5 years

Examples of Financial Instruments

Which tool will be most needed in the next 2-3 yrs? What is ahead of us?

- Huge growth of non performing loans world wide
- Although near-zero interest rates over last 24 months
- Envisaged termination of ultra expansive monetary policy over next 18 months both in EU (first) and USA (later)
- National debts and budget deficit will bite financial markets
- SHOULD WE EXPECT A NEW AND STRONGER CREDIT CRUNCH?
- CREDIT RATIONING AND HIGH COST OF BORROWING AHEAD?
- ONLY HIGH YIELDING INVESTMENTS SHALL ACCESS FINANCE?
- WHICH IMPACT ON RURAL ENTREPRENEURS IS TO BE EXPECTED?