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Rural development
financial instruments:
New opportunities to
tackle the economic crisis

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Rural development financial instruments: opportunities, experiences and challenges

Innovative proposals for rural development policy in the period 2014-2020 are likely to result in the introduction of measures to increase the capability of EU Member States to help rural enterprises access the finance they need to grow their businesses. This is expected to increase business-led rural development activity and economic growth throughout the EU countryside. These new development opportunities for rural Europe build on the options that exist within the current rural development policy framework to access different types of financial support.

Financial engineering instruments (often shortened to 'financial instruments') exist in many different forms. They include Loan Funds, Guarantee Funds, Venture Capital Funds, Equity Funds and Interest Rate Subsidy schemes. The common denominator between these instruments is that they provide an alternative option to grant funding and they can all recycle the initial allocation of monies used to set up the funds and thus stimulate further rural development.

Such financial instruments can be used by Member States in their Rural Development Programmes (RDPs) to help

channel co-finance from the European Agricultural Fund for Rural Development (EAFRD) into business support projects covering a wide range of rural enterprises. Use of EAFRD financial instruments in RDPs has been limited to date, but demand is increasing and this is expected to further intensify as more flexibility is introduced.

Flexible approaches to the rules governing RDPs use of financial instruments are being proposed for the next round of EAFRD support. The intention is to encourage the use of RDP financial instruments in a way that complements grant

Abbreviations and acronyms used in this issue of Rural Review

CELF	Community Enterprise Loan Fund	ISMEA	Institute of Food Services for the Agricultural Market
CSF	Common Strategic Framework	ITI	Integrated Territorial Investment
CIP	Competitiveness and Innovation Framework Programme	JASMINE	Joint Action to Support Microfinance Institutions in Europe
DG REGIO	European Commission's Directorate-General for Regional Policy	JEREMIE	Joint European Resources for Micro to Medium Enterprises
EAFRD	European Agricultural Fund for Rural Development	JESSICA	Joint European Support for Sustainable Investment in City Areas
ECA	European Court of Auditors	MFI	Micro-finance instrument
EIB	European Investment Bank	NGO	Non-governmental Organisation
EIF	European Investment Fund	NRDP	National Rural Development Plan
ENRD	European Network for Rural Development	NRN	National Rural Network
ERDF	European Regional Development Fund	RCGF	Rural Credit Guarantee Fund of Romania
EU	European Union	RDP	Rural Development Programme
ESF	European Social Fund	RFTF	Rural Finance Task Force
HOL	Highland Opportunity Limited	SME	Small and Medium sized Enterprise

funding support, thereby making investment projects and rural economic growth more realistic and attainable.

For example, a rural business that receives an RDP grant to cover a proportion of an investment may also, in the future, be able to secure assistance from an RDP-funded Loan Fund to help finance part of the remaining proportion. In addition, the same business might be able to make use of other financial instruments, such as an RDP-funded Guarantee Fund, to obtain a bank guarantee for a loan. Interest-Rate Subsidy schemes, Venture Capital Funds and equity options co-financed by RDP resources could also provide other useful services that contribute to making investment projects more feasible for rural businesses. All such RDP support

would be subject to compliance with State Aid and other pertinent EU rules.

Information gap

At present, an information gap exists about the RDP financial instruments' potential as a tool to stimulate rural development and tackle the challenges presented by the global economic crisis. Hence, this 13th edition of the *EU Rural Review* helps to explain why, when, where and how different types of RDP financial instruments can be used to contribute to policy goals for rural development, and wider EU economic development.

The articles draw on experiences from other EU funds and highlight key lessons learned from people involved in

coordinating successful financial instruments. Attention is focused on a group of financial instruments that are new to the majority of RDPs. The main issues involved in choosing and using these types of financial instruments are discussed and examined by informed stakeholders.

The release of this publication by the European Network for Rural Development (ENRD) is timely, as it coincides with the preparations underway for the next generation of RDPs. Another important objective, therefore, is to raise awareness among RDP stakeholders about the opportunities and considerations involved in using financial engineering tools to strengthen development in rural Europe.

Financial engineering instruments and Rural Development Programmes

A total of 88 Rural Development Programmes (RDPs) are currently being implemented in the EU Member States. Between them, they have a budget from the European Agricultural Fund for Rural Development (EAFRD) of €96.2 billion (at 2011 prices). This EAFRD financial support can be divided into two main categories, non-repayable grants and financial engineering instruments.





“Demand from rural businesses for our RDP has been extremely high and that led to a huge number of approved applications. In order to extend the reach of our RDP, we decided to use financial engineering instruments. In this way, we supported more than 750 applicants, covering more than €275 million worth of rural development projects.”

Viviana Vasile, Support Unit - Romanian Rural Network

The EAFRD is the main source of co-financing for Member States' RDPs and most of it is allocated using grant-type support systems. One of the strengths of the RDPs' grant-type support instruments is that they are able to attract significant demand, because this form of support does not need to be repaid. This enables beneficiaries (especially rural small and medium-sized enterprises (SMEs) without sufficient money to fully fund their projects through internal resources and/or commercial capital) to access non-repayable funds that can be used to part-fund projects. Such projects contribute to the development of rural areas by increasing competitiveness, maintaining jobs, introducing new

products and services, or improving quality standards.

However, the apparent strength of grant funding 'hides' a number of weaknesses associated with non-repayable development aid. For instance, this approach can, potentially, introduce inefficiencies into the market and lead to the misallocation of scarce resources. Sometimes, recipients of grant money may also regard the financing as 'free money' and, therefore, a risk occurs that the necessary financial diligence is not fully applied.

In addition, for the most part, grants are paid retrospectively; after the relevant project component has been realised and

financial proof has been submitted. The scope for advance payments is limited, and the sometimes complex administrative procedures to access grant funding can also potentially hamper such funding systems. Another disadvantage of a grant is that once it is utilised, it disappears from the 'public purse' and cannot be re-used.

RDPs that are based solely on grant support systems may, therefore, experience limitations in their overall potential to support rural development. However, innovative financial engineering instruments can form part of an RDP's funding toolkit and these can offer complementary benefits to conventional grant-based

approaches. One of the main benefits is that the funds within the financial instruments can be recycled for further rural development.

Recycling RDP funds

To improve the availability of capital for rural investment and promote the efficient use of rural development funds, the European Commission has provided Member States with the possibility to apply financial engineering actions in the form of Guarantee, Loan and Venture Capital Funds. These financial instruments can be recycled and used to facilitate further and additional access to funds for agricultural, the

food industry and other rural sectors. Recycling in this context means that the initial allocation of public funds is used on an on-going basis to support different RDP beneficiaries. Hence, more and multiple development benefits are possible for rural areas for a given amount of public funding.

Financial instruments can be set up through Holding Funds or through direct contributions to Equity Funds, Loan Funds and Guarantee Funds. The beneficiaries of financial instruments can be SMEs, as well as other organisations such as community or social enterprises, public-private partnerships and bodies such as trusts, established to supervise

specific projects, such as a rural energy initiative, for example.

In addition to recycling public funds, financial engineering instruments also have the potential to leverage capital, i.e. draw in additional private or other public funding, and to encourage recipients to introduce better financial management and business planning, due to the non-grant nature of the funding, and thus contribute to a more sustainable business environment.

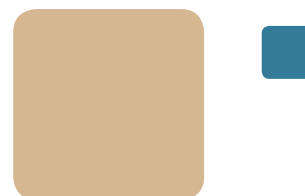
For rural businesses, there could be the added benefit of building up a good track record and becoming better prepared for commercial creditors and investors. This



effect is due to the similarity of some criteria used in financial engineering instruments (in particular, for the Loan Funds) to those applied by commercial financial institutions to assess recipients' creditworthiness. Such criteria may include the availability of guarantees or collateral, the perceived ability to repay the loan, the company track record and the quality of the management.

In the 2007-2013 programming period, the legal basis for EAFRD financial instruments is provided by Article 71(5) of Regulation (EC) No 1698/2005 and Articles 49-52 of Regulation (EC) No 1974/2006. Table 1 summarises some of the main types of financial engineering instruments that are possible within RDPs.

The advantages of the financial engineering instruments presented in Table 1 include their potential to offer more favourable conditions for rural development projects than those offered by banks or other, purely commercial lending institutions. In addition, the scope of RDP Guarantee Funds may facilitate better access to commercial credit, while Interest Rate Subsidies can ease rural SMEs' debt repayment by reducing the amount of interest to be paid from their own means.



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Table 1: Review of potential RDP financial engineering instruments

Loans from revolving Loan Funds

Definition

A loan is a form of financial debt including the principal (the amount lent by the lender) and the interest (the cost of the loan). The obligations of the borrower and lender related to repayment (and any guarantees) are defined in a contract (legal loan or credit).

A revolving Loan Fund refers to a source of money from which loans are made for multiple small business development projects. The issue of other loans for new projects is made possible as individual projects pay back their loans.

Utility

Loan Funds using EAFRD co-financing can offer more favourable conditions to SMEs than commercial credit. This type of financial instrument can be ideal for SMEs that are able to comply with EAFRD funding criteria, but unable to secure commercial credit.

Venture Capital (V/C) Fund

Definition

A VC Fund is private financial capital usually targeted at early-stage, high-potential, high risk businesses. A VC Fund makes money by taking equity in the companies it invests in, which usually have a novel technology.

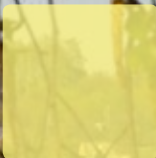
In exchange for the high risk that can be involved in investing in smaller, unproven business ventures, the VC Fund can sometimes take significant control over company decisions, in addition to a significant portion of the company's ownership (and value).

Utility

A VC Fund may be relevant if an analysis of SMEs in an RDP territory confirms that the rural businesses there demonstrate development potential and a strong capacity for innovation.

VC Funds can be considered attractive for new companies with limited operating history that are too small to raise capital on the public markets and which have not reached the point where they are able to secure a bank loan.

These financial instruments may also be appropriate in cases where SMEs are willing to give up some control over company decisions.



Interest Rate Subsidy

Definition

In the frame of RDPs, Interest Rate Subsidies are a means of supporting the payment of interest on loans. These are based on a calculation method indicated in the Member State's RDP.

Utility

Offering an Interest Rate Subsidy can be appropriate in situations where a critical mass of rural businesses demonstrate that they are able to secure loan funding (e.g. have adequate collateral or can provide guarantees required by commercial lending institutions), but the SME owners are uncertain about the stability of their company cash flow. Loan funding may be considered a risk by the SME and hence prevent the SME from committing to the loan (and thus stop them from carrying out the development project). An Interest Rate Subsidy scheme could help provide a financial cushion for such SMEs and give them the confidence they need to proceed with their projects.

Guarantee Fund

Definition

A Guarantee Fund is used to provide a financial guarantee for credit sought by a rural business or organisation and eases access to funding from banks. The Guarantee Fund deposits an amount that is used by the bank as collateral for the credit it provides to the rural development project. Once the credit is paid back, the guarantee is released by the bank back into the Guarantee Fund.

Utility

A **Guarantee Fund** is a suitable option if analysis of SMEs in an RDP area confirms that a critical mass of SMEs exists that are not able to provide sufficient guarantees or collateral to secure credit from commercial sources.

Use of the Guarantee Fund option can increase such SMEs' ability to successfully apply for commercial credit.

Equity Fund

Definition

An Equity Fund takes an ownership interest in a company, represented by the shares issued to investors.

Utility

An Equity Fund may be relevant if an analysis of SMEs in an RDP territory confirms that the rural businesses there demonstrate development potential, have a strong capacity for innovation, and remain open to the idea of having external shareholders influence the company's decision-making processes.

RDP co-finance for Equity Funds can be considered attractive for new companies, with limited operating history, that are too small to raise capital on the public markets, and which have not reached the point where they are able to secure a bank loan.



Experiences from other EU development initiatives, such as the Structural Funds, show that financial engineering instruments can also leverage considerable private sector funding. This means that EU funds allocated to financial engineering instruments can 'go further', not just because they are recyclable but also because they use a smaller proportion of EU funds to achieve the same result - hence leaving more funds available for other SME investment projects.

Such leverage effects¹ have been demonstrated, in varying degrees, in different Member States that use financial instruments. These experiences indicate that RDP use of financial instruments can have a powerful catalytic effect, unlocking private financing and other public sector funding.

In addition, experience from the Structural Funds also suggests that RDP funds that are channelled through financial instruments could be augmented by interest, dividends and other gains, creating further scope for investment in rural

development. It has also been shown that the participation of private sector funding partners provides specific expertise and knowledge regarding, among other things, how to improve the performance of the enterprises or organisations leading the rural development project, which leads to better quality projects and greater financial discipline.

Current state-of-play

Nevertheless, despite their advantages, analysis of the uptake of the financial engineering instruments presented in Table 1 shows that only eight Member States have indicated an interest in such EAFRD instruments. These are Belgium, Bulgaria, France, Greece, Italy, Latvia, Lithuania and Romania. These countries are providing support through RDP Axes 1 and 3, targeting activities under measures 121 (modernisation of agricultural holdings), 123 (adding value to agricultural and forestry products), 312 (business creation and development) and 313 (encouragement of tourism activities). The estimated total public expenditure for such RDP

financing tools is around €531 million between 2007 and 2013. This represents a very small proportion (0.3%) of the 88 RDPs' overall budget.

RDP financial expenditure data indicates that only five Member States (Bulgaria, Italy, Latvia, Lithuania and Romania) are actively using EAFRD financial instruments. The most popular non-grant type financial instruments are Loan and Guarantee Funds. None of the Member States that have introduced financial engineering instruments into their RDPs have set up a Venture Capital Fund or instituted an Interest Rate Subsidy scheme (as of May 2012).

A study² carried out by the European Network for Rural Development (ENRD) in 2012 identified some of the barriers, as perceived by RDP stakeholders, to a wider use of financial instruments in the current EAFRD programming period. The feedback from RDP Managing Authorities was that financial instruments were seen as requiring additional management resources, and there was uncertainty about the complexity of additional control rules that would need to be applied. Concern was also raised about the risk of incurring financial corrections and budget cuts if the financial instruments were not operated properly, and some Managing Authorities believed that demand was not strong for RDP financial instruments because the commercial market was able to fulfil rural SMEs' investment needs.

Under the current EAFRD regulation it is difficult to combine RDP grants with support from financial instruments and this can act as a further disincentive for Managing Authorities.

The relatively low up-take of financial instruments by the 88 RDPs in the current EAFRD programming period is in part attributed to these issues and concerns.

(1) European Court of Auditors Special Report No.2/2012. Financial instruments for SMEs co-financed by the ERDF.

(2) http://enrd.ec.europa.eu/app_templates/filedownload.cfm?id=E6109191-9B8E-3ACA-BE4F-780D87307DC1

Future prospects

Due to the advantages offered by financial instruments for RDP applicants and administrations, greater emphasis is expected to be placed on financial engineering instruments in the next EAFRD programming period (between 2014 and 2020). This process will be assisted by the introduction of a Common Strategic Framework (CSF)³, which will set out common and consistent implementation rules for EU Funds under shared management.

The new CSF toolkit will include greater and clearer scope for the uptake of financial engineering instruments. RDPs will be able to make use of these new opportunities to introduce a broader range of options, to help potential beneficiaries gain access to EAFRD co-financing in the RDPs.

One of the main anticipated CSF innovations concerns the provision of adequate flexibility to allow RDP financial instruments to be used in combination with conventional grant schemes. The aim behind this increased flexibility is to improve rural SMEs' access to RDP financial support. In such circumstances, farmers and other beneficiaries of RDP grant support would be able to use financial instruments to cover the guarantees that are required for some investments.

Other options will allow enterprises to combine RDP grants with RDP loans from a financial instrument, in order to cover a higher proportion of the total project costs. This could make it easier for rural SMEs to achieve the total financial package required for a project, and so should act as an incentive to encourage more people to invest in rural development initiatives.

The socioeconomic and environmental fabric of Europe's countryside could benefit from such an upsurge in development activity. Thus RDP financial instruments present many possibilities for helping Member States to find new ways of tackling the economic crisis in rural areas.

For such reasons, rural development stakeholders are increasingly interested in understanding the potential scope of different financial engineering instruments in supporting EAFRD implementation. Further information is presented in the following sections, which explains in more detail how the EAFRD can be used for such purposes, what the important issues are, and what the future might hold for EAFRD financial engineering instruments.



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(3) Title IV of Common Strategic Framework regulation (Articles 32-40)

Guarantee Funds help rural SMEs secure access to development finance

Guarantee Funds play an important role in facilitating rural development activity because they can help rural businesses secure full funding packages for their development projects.

Typically, a farm or other rural SME that successfully applies for an RDP grant to help finance a development project receives a proportion of the overall project capital. The business still needs to find the remaining funds for the investment. A bank loan could be used to cover the remaining proportion, but most banks ask for some kind of loan security in order to protect their money

should the project fail. Without this security, the SME may not be able to receive a loan and implement the development project. A Guarantee Fund can fill this financing gap by offering security, in the form of a guarantee to pay back the bank loan in the event that the project fails.

The EU Structural Funds have an established track record in providing the co-financing that is needed to set up such Guarantee Funds, and Rural Development Programmes have also started to use co-financing from the EAFRD for similar purposes.



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In southern Italy, for example, a Guarantee Fund is using EAFRD co-financing to improve access to rural finance for farmers who want to invest in improving the competitiveness of their business activities. This Fund is managed by the Institute of Food Services for the Agricultural Market (ISMEA), which is a public sector body closely aligned to the Ministry of Agriculture.

Giorgio Venceslai from ISMEA explains: "in Italy we have a central Guarantee Fund, but this does not cover agricultural business, and we were aware that farmers were concerned about problems they experienced in accessing loan guarantees from commercial sources for their development projects. It was especially difficult for business start-ups and young entrepreneurs in the farming sector to obtain such financial help. In addition, the introduction of the new bank capital regulations (known as Basel II) implied that there was a need for a State guarantor to provide a more powerful protection in order to improve the risk rating of farmers."

These issues drove the demand to set up a Guarantee Fund for farmers that was co-financed by the EAFRD. ISMEA is fully responsible for managing the Guarantee Fund, which was designed under the supervision, and with the support of the Ministry of Agriculture. The Fund's operating rules (such as caps and procedures) were developed with input from the farmers' unions and the Italian banking association.

Mr Venceslai explains how the financial instrument works: "a farmer goes to the bank and applies for a loan. The bank assesses the request, taking into account the credit rating of the farmer and the financial sustainability of the project. If the securities or guarantees provided by the farmer are not sufficient then the bank sends a guarantee request to our Fund. The farmer does not make the request himself, it is made only by the bank. Our Fund targets SMEs, so larger enterprises cannot be guaranteed. We can cover up to 70% of the loan for most businesses and this can increase up to 80% in the case of young farmers. Micro or small enterprises are not eligible for guarantees valued at over €1 million and a cap of €2 million is in place for medium enterprises."

Some useful lessons have already been learnt from the Italian Guarantee Fund experience. "Initially, many farmers thought it was for free and the guarantee was a type of 'gift' from the State," says Mr Venceslai, who continues, "so the main challenge was to explain to farmers that although the Guarantee Fund was to help them, it had to respect basic financial principles and that the business still had to be responsible for its own risk, rather than the Fund. Sometimes we are not able to help every farmer because we have to protect the Fund from projects that, for various reasons, are assessed to be too high risk."

Reinforcing this point and reflecting on the key success factors involved in managing a Guarantee Fund using EAFRD co-financing, Mr Venceslai notes, "we are still relatively new but I can already highlight five key lessons. Firstly, a Guarantee Fund needs a robust risk rating model. This is fundamentally important. Secondly, a long-term view of the activity is beneficial, especially during the first years, which can be quite challenging. Thirdly, a good information technology system is an essential tool. The fourth point to note is that a successful fund needs skilled employees, who are able to manage the guarantee requests and understand both the banks' and the farmers' needs. Last, but by no means least, is the importance of having a strong alliance with the farmers' unions and the banks."

These success factors are highly relevant for other Guarantee Funds using RDP funds to help improve access to development finance for rural businesses. Another example is found in Romania, where EAFRD resources have been used to establish the Rural Credit Guarantee Fund of Romania (RCGF).

Speaking about the rationale behind the RCGF, its Deputy General Director, Ileana Bratu, says: "the Rural Credit Guarantee Fund of Romania was introduced following our experience of working with the EU's SAPARD pre-accession programme, which provided funding support for rural areas. This work identified the problems that were faced by rural businesses in accessing credit. Such problems created an obstacle to development in rural areas, which was a high priority for support, and also hindered the uptake of funding assistance provided by the EU."

"Under these conditions it was considered necessary to develop a financial instrument that could increase access to funding in the National Rural Development Plan (NRDP) by improving the ability of businesses to obtain credit to finance private contributions to rural investment projects." This demand for a Guarantee Fund was described in the NRDP, and the Managing Authority had a significant involvement in the design of the RCGF.



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It was considered useful to provide flexibility in the RCGF so that it could assist different types of rural businesses. As such, it includes EAFRD co-financing from both Axis 1 and Axis 3 of the NRDP (e.g. measure 121 - modernisation of agricultural holdings; measure 123 - adding value to agricultural and forestry products [including the corresponding state aid schemes]; measure 312 - support for the creation and development of micro-enterprises; and measure 313- Encouragement of tourism activities).

As with the Italian case, the RCGF provides guarantees which cover up to 80% of the loan requirement. Ms Bratu notes that, "the guarantee is provided in the loan currency and the guarantee validity period can be equal to the loan tenor, plus a period of up to 60 calendar days. Once approved, the guarantees can be payable within 15 days after we receive a request from the bank to cover a loan application from an eligible business. We have good working relations with the banks, and agreements have been established to ensure that the banks notify the Fund about any event that might result in a credit risk."

Further information:

Italy: <http://www.ismea.it/flex/cm/pages/ServeBLOB.php/L/IT/IDPagina/113>

Romania: http://www.madr.ro/pages/dezvoltare_rurala/Brosura-FGCR-2010.pdf

The scope for financial engineering instruments under EU rural development policy





Support from the European Agricultural Fund for Rural Development (EAFRD) can be distributed as grants or in the form of more innovative financial engineering instruments. Moves towards greater alignment of EU funding rules are expected to help facilitate a broader menu of EAFRD financial instruments in the future.

The range of rural businesses and development organisations that can benefit from EAFRD financial engineering instruments is vast and includes all sections of the agricultural sector, food industry enterprises, forest owners and forest managers, as well as non-agricultural micro-businesses operating in rural areas, farmers diversifying their activities into non-agricultural business, enterprises operating in the field of rural tourism, and enterprises developing rural heritage projects.

Such a significant scope for EAFRD support offers many rural development opportunities and it is possible (subject to compliance with rules concerning State-Aid or Overcompensation⁽⁴⁾) for beneficiaries to combine support from various EAFRD financial instruments. These instruments can invest in, or provides guarantees to, enterprises and organisations during their start-up and early stages of development. Proposals for growth and expansion can also be supported using EAFRD financial instruments.

Interest in EAFRD financial instruments at Member State level has continued to grow and the current EAFRD legal framework provides a flexible basis action. However, certain criteria and conditions are included in the legal framework, such as restrictions on using the EAFRD to support firms that are classified as being 'in difficulty'. Other aspects of the regulatory framework reinforce the need for the effective use of EAFRD financial instruments, including the reuse of resources allocated to such instruments to finance further financial engineering actions.

(4) For information about State-Aid and Overcompensation see: http://ec.europa.eu/competition/state_aid/studies_reports/sme_handbook.pdf

Designing EAFRD financial instruments

A clear process for designing EAFRD financial instruments is needed, and Member State authorities should follow a number of key steps to set up a new fund. This involves, firstly, carrying out internal discussions at national or regional level to identify the demand for a new fund, and confirming the necessary political support for this approach. Amendments to the Rural Development Programme (RDP) may be required, as well as to national or regional rules concerning EAFRD administrative procedures. Once the legal foundations are in place, a fund manager is selected and an agreement is signed between the Managing Authority and the manager of the fund.

Intermediary organisations may then be selected to help implement and promote the fund. These can also contribute to the essential monitoring and control systems that form part of the fund manager's reporting obligation to the Managing Authority. Agreeing protocols for the closure of a fund is another important aspect that needs to be considered during the design and start-up stages. It may take around six months to carry out all these preparatory steps, prior to the launch of the fund.

The Managing Authority and the European Commission may undertake certain pre-launch checks on an EAFRD financial instrument, to ensure that it satisfies the following criteria:

- All Funds using EAFRD co-financing must be set up as independent legal entities;
- Evidence should show that they are either newly established under an agreement between the shareholders, or constitute a separate block of finance within an existing financial institution;
- In addition, the fund must have its own distinct set of accounts that differentiate it from other EAFRD awards.

The European Commission remains outside the scheme and cannot be a partner or shareholder in the fund.

Other checks can cover the terms and conditions of the EAFRD contribution; in particular the targets for deliverables over the duration of the instrument's existence, the instrument's investment strategy and planning, its monitoring and implementation system, as well as the 'winding up' provisions for the closure of the instrument.

Once approved, co-finance from the EAFRD can be transferred to a rural development financial instrument. The EAFRD co-finance is generally paid either as a single sum or in instalments. EAFRD co-financing has to be declared as expenditure in the same year that the funds are transferred to the financial instrument.

An initial amount is transferred to allow the functioning of the fund in the first two years. The national contribution to the fund must be executed at the same time as the EAFRD contribution. The measure and axis co-financing rate (of the RDP) should always be respected and a pro-rata approach is necessary in cases where several measures with different co-financing rates apply.

As with all EAFRD projects, financial instruments need to be carefully monitored to track their performance and to provide the management information needed to steer them towards their objectives. A monitoring activity plan must be submitted at the end of each financial year to the Managing Authority.

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Monitoring activity plans for RDP financial instruments should contain information covering:

- The credit or guarantee portfolio for the coming year;
 - Data showing the exposure rate for the current year;
 - Target indicator estimates for the annual default rate;
 - Details of any modifications concerning the credit or guarantee criteria, terms and conditions;
 - A breakdown of annual management costs covered by the fund, taking into account the ceilings in the funding agreement;
 - Any other information foreseen in the funding agreement.
- All of this information is fed into the Managing Authority's own annual reports.

The Commission's proposal for financial instruments after 2013

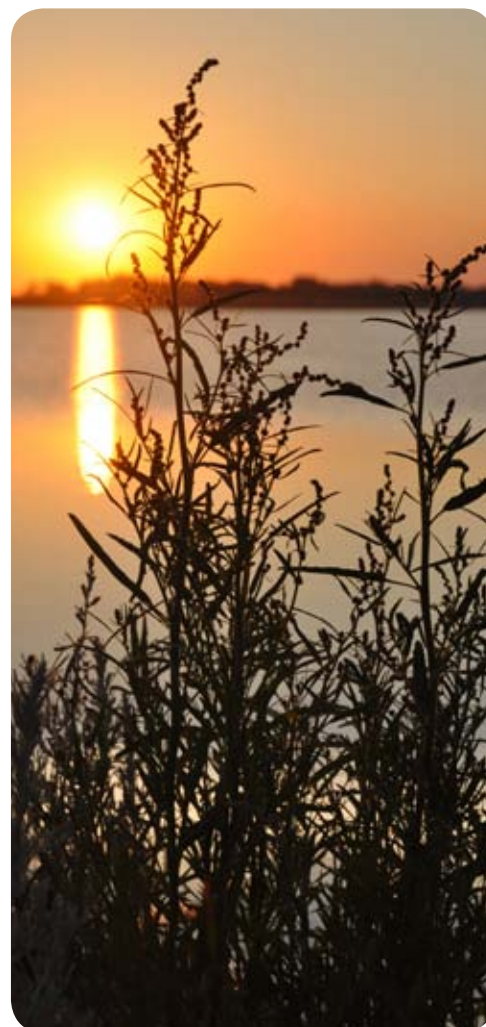
EAFRD financial instruments operating at the moment are mostly managed by publicly-owned bodies, and finance is mostly going to medium or long-term investments supporting medium to large-sized projects. Scope to further expand the reach of rural financial instruments (e.g. into smaller-scale credits and/or non-public fund management) is anticipated, following the adoption of the new Common Strategic Framework⁵ (CSF). This CSF will apply to the EU funding period from 2014 to 2020 and aims to provide a clear and common rule book for the EAFRD and other EU funds.

The introduction of the CSF rules will see the EAFRD becoming a core component of the 'CSF Funds'. The CSF Funds will also include the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Cohesion Fund (CF) and the European Maritime and Fisheries Fund (EMFF). The CSF is to be sufficiently detailed to provide genuine improvements in the coordination between EU funds, but sufficiently flexible

to allow each policy covered to fulfil its respective mission. Provisions on financial instruments are part of Title IV of the proposed CSF Regulation (Articles 32-40). It is important to note that no new legal rules governing financial instruments are proposed for the new EAFRD Regulation and the CSF will act as the main reference here.

This approach is being proposed to simplify and harmonise policy delivery by clarifying the rules around access to complementary funds for administrations and applicants. It will help to optimise synergies between the CSF Funds, and lead to improvements in each fund's effectiveness and efficiency. Harmonisation is anticipated concerning the rules for eligibility, monitoring, reporting and evaluation, implementation and control requirements. These would all apply to EAFRD financial instruments.

This more comprehensive legal framework will provide clear rules to enable more combinations of financial instruments with other forms of support, in particular with grants. This should make a wider range of options easier to implement, and stimulate the design of well-tailored assistance schemes.



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(5) See Commission Staff Working Document "Elements for a Common Strategic Framework 2014 to 2020 the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund SWD(2012) 61 final

A number of new developments in the management of rural financial instruments have also been proposed. Options for 'funds of funds' using co-financing from more than one EU source are being discussed, and proposals to give Managing Authorities the option of directly managing RDP Loan and Guarantee Funds are also included in the draft CSF regulation. EU bodies - like the European Investment Bank or European Investment Fund - could also take on new partnership roles in instruments that include EAFRD co-finance. Similarly, an international financial institution in which a Member State is a shareholder could also play a role in using the EAFRD to support the development of rural areas. Possible options may exist for an instrument to be set up at EU level, and, interestingly, CSF flexibility also provides scope for EAFRD instruments to be used in a transnational or cross-border context.

Another noteworthy aspect of the CSF refers to the provision of 'off-the-shelf' models for financial instruments. These aim to help simplify the process of setting up financial instruments at Member State level. The models aim to draw on best practice approaches to the planning, implementation and evaluation stages in the programme cycle of different

financial instruments. They are also being prepared to work in different operating circumstances and to allow the needed flexibility for Member States authorities to adapt them to their own specific territorial development needs at national and/or regional levels.

Ex-ante planning

One of the most important aspects of the draft CSF regulation regarding financial instruments is the reference to the relevance of preparatory work. In order to ensure that the RDP funds are being used to target demand-led activity, all financial instruments are to be required to make an appropriate ex-ante assessment. Each financial instrument will require its own ex-ante analysis to determine the market demand for the support. This is aimed at encouraging the design of well-informed financial instruments that address gaps in funding services.

Each new financial instrument would, therefore, have to address development needs that have been confirmed by an accurate gap assessment. The ex-ante analysis would assess the market demand and match the fund size accordingly. Added value would also need to be demonstrated to ensure that the right

type of financial instrument was being proposed to address the identified market failures or funding gaps. This good practice approach to planning rural development assistance should reduce any risk of overlap with existing financial supports. The ex-ante assessments would need to be transparent and subject to audit. If correctly applied, they represent a useful tool for strengthening the quality of EAFRD outcomes and encouraging coherent approaches to public fund management.

Assessments could be integrated as part of the ex-ante evaluations carried out during the design of the 2014-2020 RDPs, or undertaken during the next programming period, prior to the launch of a new financial instrument.

Questions about how CSF funds could be used after the closure of the 2014 – 2020 programmes still have to be clarified. Because financial instruments recycle funding, these instruments may continue after 2020. It is anticipated that resources and gains attributable to an RDP must be used for a period of at least eight years after the closure of the RDP, and during that time the funds must continue to be used in line with the RDP's aims.



Ex-ante assessments for rural financial instruments: good practice approaches

A review of EU-funded financial instruments by the European Court of Auditors⁶ identified good practice approaches to ex-ante assessments. A 'gap assessment' carried out by the European Investment Fund (EIF) in Sweden was highlighted as representing a model that could be useful for replication elsewhere.

- The EIF's gap assessment was finalised in January 2007 and included:
- A full nationwide analysis of the supply of, and demand for, SME finance, by type of financial instrument and, where applicable, taking regional specificities into account;
- Areas where the existence of financing gaps could or could not reasonably have been established;
- References to previous and other EU support that could address the financing gaps;
- Information on the intended structuring of the co-financed funding (fund allocation), including a link to the operational programme submitted to the Commission for approval;
- Information on potential financial intermediaries capable of implementing the funding scheme.

The analysis of the need for SME financing support was carried out through a consultation process, which received input from a wide spectrum of market participants, in both the public and private sectors. A programme of interviews with key stakeholders was followed by a large workshop.

Valuable ex-ante insights into the state-of-play concerning SME demand for financial assistance were gained from the gap assessment, which assisted in the subsequent design and implementation of EIF support to SMEs in Sweden.



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(6) http://enrd.ec.europa.eu/app_templates/filedownload.cfm?id=E610A03D-963D-173A-D287-6451904FC151



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The Swedish Perspective

The Swedish Rural Network Capital Group was established to address the imbalance between rural decline and metropolitan growth, whereby investment was flowing to the cities but there was dwindling investment in rural areas. The Group wanted to find out whether investors did not see large enough potential returns from rural enterprises or if there was a lack of entrepreneurs providing compelling investment opportunities. They wanted to know what was holding one or both of these groups back.

Only a small percentage of rural businesses stated that they had difficulties in finding investment. However, the Group, comprised of individuals with extensive experience in various aspects of rural entrepreneurship and finance, are of the opinion that these results must be interpreted carefully. Business expansion is stymied. Rural Sweden has been in decline for many years, exacerbated by ever decreasing local services.

Agricultural enterprises reported least problems. Capital intensity is high; they have bought large and labour-efficient plant and machinery using their land and forest as collateral. In contrast, other business owners are forced to choose between mortgaging (and risking) their family home or not taking a loan at all.

The Group observed that conventional economic theories and concepts do not explain how globalisation and the interaction between banks and rural and urban contractors affect the local economy. Disinvestment is not a market failure; it is rather a result of leakage from the local economy. Nationwide, household savings are captured by financial institutions and reinvested in enterprises. However, rural entrepreneurs receive far less help with

financing than corporations in bigger cities. Listed corporations benefit most from globalisation and this is especially true in times of financial crisis.

The Group also considers that rural financial institutions, savings banks and cooperative banks, originally set up to promote the local economy and the financial interests of its members, have turned into profit-focused bodies. These institutions have been instrumental in driving a long downward spiral, whereby a diluted local economy leads to even more dilution. Banks see greater risks and lower profits from investments in smaller businesses in rural areas, especially in areas with shrinking economic activity.

Regardless of what policy advisors offer as a solution to reverse this trend, most share the view that the society of the future will be constrained and fundamentally changed by the lack of cheap energy. We know that global fossil fuel supplies will decline while demand initially grows in Asia.

This means that we are facing a historically large and rapid transition of society as a whole with a highly uncertain outcome. We hope that with technological development and functioning markets, we will have time to re-allocate resources and invest in this transition. However, the risk is that we have already taken on a generally high level of debt to finance a fossil fuelled-based infrastructure that is becoming obsolete. Enterprises, both rural and urban, will need to rapidly rearrange their balance sheets and, despite being in debt, have to find a way to procure new infrastructure without incurring even more debt.



Supply and demand for rural financial engineering instruments

Financial engineering instruments are supporting European rural SMEs using various funds available, from EAFRD to Structural funds, and demand is growing at a steady pace while an information gap about the options available to them still exists. In rural parts of some Member states SMEs are excluded from financial support from lending institutions determining a 'rural financing gap' as a recent survey conducted by the ENRD Rural Entrepreneurship Thematic initiative on Rural Finance demonstrated.

Rural areas are estimated to generate 48% of the EU's gross value added and provide 56% of the 27 Member States combined employment. An important characteristic of the rural economy is that it contains mostly small and medium-sized enterprises (SMEs), many of which are micro-businesses with a high proportion of self-employment. These rural SMEs represent a large potential client-base for financial engineering instruments.

Rural SMEs clearly have considerable potential to create employment, and they can play an important role in the recovery from the current global economic crisis. Access to finance for SMEs' economic growth and development is widely recognised as a crucial element for Europe's economic recovery.

A synthesis report from the European Commission⁷ reveals that nearly 300 financial instruments are being used to provide Structural Fund support to businesses in the EU Member States in the period 2007-2013. These comprise Loan Funds (43%), Equity Funds (36%) and Guarantee Funds (21%). The combined support budget for SMEs totals €7.4 billion and, by the end of 2010, the funds had assisted 20 858 investments in enterprises, using €3.150 billion to mobilise some €4.3 billion of overall development funding. This helped to create and/or safeguard around 91 000 jobs. Many of these financial instruments

operate in rural areas but they are often limited to supporting non-agricultural activities. However, farmers, foresters and agri-food businesses have similar development needs to other businesses, and so demand would appear to be high for financial instruments within Rural Development Programmes (RDPs), to fill this gap.

Various financial institutions are in the business of supplying SMEs with development finance. A study by the World Bank⁸ confirmed that the range of providers of financial services to rural SMEs stretches from informal to formal institutions and includes: public, private and cooperative banks, other financial institutions, non-governmental organisations (NGOs), micro-finance institutions, community-based financial organisations and money lenders.

EU and national development assistance is also available for SMEs through different sources of co-financing, including the European Agricultural Fund for Rural Development (EAFRD), the Structural Funds, the Competitiveness and Innovation Framework Programme (CIP), and the European banks, such as the European Investment Bank, amongst others.

Demand trends

Demand from SMEs for financial assistance continues to follow a number of

patterns that are monitored by Eurostat. The key demand trends observed for EU SMEs include:

- A shift has occurred in SME behaviour in the EU since 2009, with increased reliance on external financing (i.e. not from own resources). The proportion of SMEs using external financing rose from 27% to 56% (on average) in the Eurostat sample;
- Most SMEs in the Eurostat survey noted that their main reason for seeking external finance was to create working capital, or to purchase land, buildings, equipment or vehicles;
- Most requests for external assistance from EU SMEs are for less than €100 000, although significant demand does exist for loans of up to and over €1 million;
- Bank loans remain the most widely used source of external finance for SMEs;
- Only a very small proportion of SMEs use 'other financial institutions' as a source of external finance;
- SMEs in the Eurostat survey felt that banks are becoming less willing to provide loan funding and an improvement in the supply of bank loans was not anticipated in the immediate future;
- The SME success rate in obtaining external finance fell between 2007 and 2010. The proportion of partially successful or unsuccessful requests for loans doubled in this period.

A supply-side market failure is apparent. While SMEs' reliance on loans for their external funding needs continues to



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(7) Titled: *Financial Engineering Instruments Implemented by Member States with ERDF Contributions. Programming Period 2007-2013.*

See http://ec.europa.eu/regional_policy/thefunds/doc/instruments/financial/financial_engineering_report_2012.pdf

(8) The World Bank (2007). *Community-based Financial Organizations: A Solution to Access in Remote Rural Areas? Agriculture and Rural Development Discussion Paper 34.* Accessible at: <http://siteresources.worldbank.org/INTARD/Resources/combasedfinance.pdf>

increase, banks' willingness to provide such loans is declining, and with it the actual supply of bank loans.

Information about how such trends and issues specifically affect rural businesses is limited. This information gap is attributed to two reasons: firstly, surveys tend not to specify whether individual SMEs in a survey sample operate in predominantly rural, intermediate, or predominantly urban areas, thus making it difficult to draw any conclusions relating to rural enterprises; secondly, some surveys of SME access to finance exclude SMEs whose activities relate to agriculture, forestry or fishing.

Despite the absence of specific rural data, the diversity of business enterprises that operate in our countryside today provides reason to assume that rural SMEs are also affected by the aforementioned market failures. In fact, market failure could actually be exacerbated in rural areas for reasons outlined below.

Supply factors

In rural parts of some Member States, SMEs can have difficulty accessing finance to help them fulfil their rural development potential. Where rural businesses are excluded from financial support from lending institutions, rural development policy faces an acute challenge. This 'rural financing gap' can be attributed to a number of issues:

Europe's lending institutions are now applying stricter controls on the finance that they provide. This is a result of international agreements that are designed to reduce the risk of future economic crises⁹. The result is that SMEs that are considered to be high-risk from an investment point of view are experiencing increased difficulties in accessing development finance.

Some rural SMEs may be considered higher risk than other businesses because they can be seen as being more sensitive to unreliable factors such as weather or economic and seasonal fluctuations.



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Rural SMEs may also be disadvantaged by a lack of knowledge among lending institutions about the rural economy's operations and opportunities. The latter may occur when lenders are located far away from rural businesses.

A survey presented in the Final Report of the *ENRD Rural Entrepreneurship Thematic Initiative: Rural Finance*¹⁰, gathered information on commercial banks' perception of risks, trends, and preferences related to credit lines available to rural enterprises. Survey findings were based on the responses from six banks in four Member States (Hungary, Latvia, Malta and the United Kingdom) and showed that

the majority of respondent banks do not apply any special formal criteria to rural enterprises. However, the risks related to lending to rural enterprises were estimated by banks as either equal to or higher than the risks for non-rural enterprises. The findings of the ENRD survey corresponded to the results of surveys conducted for the European Central Bank and DG Enterprise and Industry.

One of the interesting findings of the ENRD survey was that banks were more inclined to welcome applications from rural businesses that were in receipt of funding support from national or EU sources.

(9) For further information about the new regulations governing banks and other financial institutions see <http://www.bis.org/bcbs/basel3.htm>

(10) http://enrd.ec.europa.eu/app_templates/filedownload.cfm?id=84638378-F1F0-1325-D38A-E3A85D31B8B4

Development proposals that had already been scrutinised via public sector 'due diligence' checks were considered to carry less risk. For example, projects that had already been screened against EAFRD eligibility criteria would be looked on more favourably by lenders. Banks considered EAFRD co-financing to be important because it helps to safeguard cash-flow, provides better overall viability, and leads to higher quality projects.

Other factors affecting the perceived risks attributed to rural SMEs by lending institutions relate to the overall business acumen and capacity of rural firms. Businesses need to be able to convince financial institutions of their project's viability and creditworthiness. Hence, SMEs that are able to demonstrate personal know-how about business and financial planning, risk management and self-assessment techniques are more likely to receive support from lenders. Conversely, SMEs that are not able to adequately explain their competitiveness and growth potential may not be able to convince lenders of the merits of their proposals.

Access to appropriate business support schemes for rural SMEs (including affordable business advisory services and technical assistance) is, therefore, another inter-related factor that can influence the

rural financing gap for SMEs. In addition, a lack of relevant information about the availability of business financing options may also hinder both the supply of, and the demand for support¹¹.

Rural Development Programme opportunities

Conclusions from this overview of the supply of, and demand for rural financing indicate that whilst the demand for financing exists, an array of supply-side obstacles may prevent rural SMEs from securing finance for their development projects. Consequently, market failure trends may be a driving force behind rural SMEs seeking out other, alternative sources of funding in order to survive.

An expansion of financial engineering instruments provided to rural businesses using the EAFRD in the Member States' Rural Development Programmes (RDPs) could play a valuable role in addressing this challenge. As noted in the previous pages of this *EU Rural Review*, RDP credit schemes (i.e. Loan, Venture Capital and/or Equity Funds) can be designed to offer more favourable conditions than commercial sources of funding. Likewise, RDP co-financed Guarantee Funds may improve access to commercial credit, and RDP co-financed Interest Rate Subsidy

instruments could help to ease rural SMEs' debt repayment by reducing the amount of interest to be paid from their own resources.

Decision-making processes regarding the expansion of these types of RDP financing opportunities need to consider many questions to ensure the proper use of public funds. These questions underscore the importance of financial engineering instruments being introduced only in cases where a thorough analysis of the rural financing gap has been undertaken.

RDP stakeholders interested in expanding the availability of EAFRD financial engineering instruments can take advantage of the lessons that have already been learnt from other EU policy areas. Cohesion policy, for instance, has been a pioneer of a great many financial engineering instruments, designed to support SMEs in all parts of Europe.

An interview with a cohesion policy specialist on [page 27](#) provides very useful insights into the balance between the demand for, and supply of, alternative tools for filling SME financing gaps.

Furthermore, the article on [page 21](#) covers various considerations that need to be taken into account when designing a financial engineering instrument for rural SMEs, balancing the needs and demands of the recipient and the provider.

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Highland opportunities

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Scotland's northern region contains some of Europe's most isolated rural areas, where business opportunities are limited by natural handicaps and depopulation pressures. The effects of the economic crisis have hit hard in this area, but a package of financial instruments has been designed to help the region's rural businesses to get started and to grow. Co-finance from the European Regional Development Fund (ERDF) has provided important funding to establish these financial instruments, which mainly target non-farm businesses.

A company limited by guarantee was set up by the Highland Council municipality's economic development department to manage the different funds. Highland Opportunity Limited (HOL) is a company with no issued share capital. It has one member, the Highland Council. No profit or dividend is distributed to the sole member from the company's on-going operations and any surpluses are retained for re-investment in the company's client base of micro-enterprises and SMEs.

HOL has a net asset value of £4.1 million (equivalent to around €5.15 million) and its annual investment programme is around £570 000 (equivalent to around €715 000). This comprises mostly of loans from several different funds.

Opportunity Fund

An 'Opportunity Fund' offers discretionary loans to new and growing businesses in the Highland Council area of Scotland. This Fund has been operating successfully for 26 years, during which time it has received co-financing from the ERDF. Its main priority is loans of between £1 000 and £50 000 (equivalent to around €1 250 to €62 500), which can be unsecured, where there is a strong business plan.

Loans of over £50 000 and up to £250 000 (equivalent to around €312 500) can be provided when adequate finance is available in the fund, and when there is security over a business asset. In addition, larger loans must demonstrate strong potential for generating economic development in the Highlands. Loan conditions for self-employed entrepreneurs require a personal obligation to repay, or in the case of limited companies, a directors' guarantee is needed.

Exceptionally, and where there is a business with high growth prospects and a clear investment exit route, equity investment may be considered through the Opportunity Fund.

Community Enterprise Loan Fund

HOL's Community Enterprise Loan Fund (CELf) provides loans to assist 'non-profit distributing' community-based enterprises in the Highlands. A typical client is an entity with a constitution, such as a society, club, trust or company, which does not pay any dividend or surplus to its owners, but re-invests in the business.

Many such community enterprises provide lifeline social services that may not be viable as commercial ventures in the Highlands, but survive and thrive with community support and finance. Other examples include care organisations, heritage and cultural groups, youth organisations, sports clubs and so on.

Loans of up to £50 000 (equivalent to around €62 500) are available from the CELf, at interest rates from 5%, depending on the risk profile and whether security is provided or not. The maximum duration of a loan is seven years. Loans above £50 000 may also be considered in special circumstances. The CELf received co-financing from the ERDF to help it launch its support for social enterprises. HOL also has a loan facility from Social Investment Scotland (a third sector Community Development Finance Initiative, set up by the Scottish Government in 2001).

Youth start-up support



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HOL has an agency agreement with Youth Business Scotland to support young entrepreneurs in the Highlands and Northern Isles. Through the Opportunity Fund, HOL offers loans to match the loans provided by Youth Business Scotland. In aggregate, such loans are available up to £10 000 (equivalent to around €12 500) at a fixed interest rate of 3%, and for terms of up to five years. Youth Business Scotland also offers grants of up to £1 000 (equivalent to around €1 250) in some cases, and Market Test grants of up to £250 (equivalent to around €310) to support pre-start market research.

Youth Business Scotland targets young people aged 16–25 (or up to 30 if they have a disability or are geographically disadvantaged by being located on one of the Scottish islands) who are starting or growing a business. It is particularly aimed at those who may be disadvantaged. Business planning advice, training and aftercare support from a business mentor are all part of the package of assistance.

Highland Business Growth Fund

This HOL scheme offered a two year, unsecured, interest-free debt bond to any eligible business in the Highlands that required access to finance to set up or expand.

Business sectors targeted by this Fund reflected the Highland Council's economic development priorities for HOL, as well as the priorities of the region's ERDF Operational Programme (which co-financed the Fund). These included SMEs operating in tourism and culture, energy, food and drink, life (and other) sciences and the creative industries, together with new start-ups. The retail sector was not eligible.

With a robust business plan, an eligible business could access an interest free loan, with no capital repayments during the first two-year period, to help them obtain a matching bank or other commercial loan. New business start-ups could also obtain a seed finance grant as part of the scheme, to help them launch their enterprise. The scheme operated between April 2009 and April 2010. Twenty businesses were assisted and 62 jobs created or retained as a result. Demand was high because of the attractive interest rate and the repayment holiday at a time when commercial lending was difficult to access.

Compliance concerns raised by the Scottish Government were later withdrawn but delayed reimbursement of the ERDF grant to HOL. This delay, combined with the reduced loan receipts due to the two-year capital repayment deferral, put considerable strain on HOL's cash flow and is still impacting on the funds available for re-investment.

Rural development funding

Explaining the rural development assistance provided by HOL's financial instruments, its Chief Executive, Marie Mackintosh, said: "HOL has always aimed to address the market failure in mainstream commercial lending by supporting SMEs and social enterprises that have either been turned down by, or cannot raise sufficient funding from other sources. As recessionary pressure has grown in recent years we find that bank lending policies have become stricter, and SMEs are struggling to cope as their overdraft facilities are reduced or withdrawn, adding to their operating difficulties. Our interest rates are competitive and there is normally no arrangement fee."

"While HOL is looking for growth outcomes and economic impact from our investments, we also recognise that in the current economic climate it is important to support business resilience. Many SMEs need to survive the downturn and we expect that they will thrive once trading conditions improve."

"A large part of our success is that we package our affordable financial assistance with a wide range of general and specialist business advice, which is free-of-charge, from our Business Gateway and Enterprise Europe Network staff teams."

"In the year to March 2011, HOL provided 36 loans valued at £566 000 (equivalent to around €710 000), and this supported the creation or retention of 126 jobs. In the year to March 2012 a total of 33 loans were approved, with a combined value of £597 200 (equivalent to around €750 000) and creating or sustaining 180 jobs."

"One example of how our Loan Funds have helped rural SMEs is the Isle of Skye Bakery, which was established in 2007 to provide fresh bread, biscuits and oatcakes to the local community, to substitute for imported products. By spring 2010, the business had outgrown the owner's domestic kitchen and needed to move into, and fit out, commercial premises. A HOL Opportunity Fund loan of £3 000 and a Highland Business Growth Fund debt bond of £7 800 (equivalent to around €9 800) was awarded and formed part of the £49 000 (equivalent to around €61 500) investment. The HOL support also helped to lever grant support from a local trust, as well as a £7 800 bank loan. By Autumn 2011, the bakery was in full production and three new full-time jobs had been created. The company had also opened an eco-café and a shop selling local produce. The applicants acknowledge that the HOL loans helped to attract finance from other sources."

"Another example is the nearby Isle of Skye Ferry Community Interest Company, which has received three Community Enterprise Loan Fund awards. The most recent, in December 2011, was a £25 000 (equivalent to around €31 250) unsecured loan, repayable over three years, to carry out an engine upgrade and other repairs to the ferry. The project has helped to sustain employment for five local people," adds Ms Mackintosh. "The Isle of Skye Ferry is an exemplar of a social enterprise in a remote rural location. Not only is the ferry service successful in providing employment where there are few alternatives, it has also helped to connect two otherwise very isolated parts of Scotland. The ferry offers an alternative tourist experience to the Skye Bridge, and it was called into service earlier this year when road access to the coastal village of Stronferdy was cut off for months due to a landslide."



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Learning from the EU Structural Funds' experience

Financial instruments might be relatively new to the European rural development policy toolbox, but the previous examples from Scotland highlight the fact that EU regional development policy has been making use of financial instruments for a much longer period. The importance of such tools has grown steadily, and the experience gained of channelling Structural Funds through financial instruments could provide valuable lessons for rural development policy.

EU cohesion policy provides a legal framework for the operation of a range of financial instruments throughout rural and urban Europe. In this context, Member States agree on a flexible set of implementation rules for the Structural Funds. Once in place, these EU rules and regulations then become the guiding principles for Member States, as they implement Structural Fund programmes. Details agreed within this regulatory framework set out the scope and core characteristics of Structural Fund financial instruments. Member States use the EU's regulatory framework to help them design a diverse collection of Structural Fund financial instruments.

António Gonçalves is Head of Unit for Financial Engineering and Major Projects at the European Commission's Directorate-General for Regional Policy (DG REGIO). He works very closely with Structural Fund financial instruments and reports that the use of such instruments is on the increase. "For the next programming period [2014-2020], the European Commissioner with responsibility for EU cohesion policy has indicated that he wants to triple the proportion of funding that is channelled through financial instruments. It is part of the Commission's stated aim, to emphasise the importance of using financial instruments in order to close the gap between scarce public resources and investment needs, and also to attract the participation of the private sector."

As noted earlier in this edition of the *EU Rural Review*, money from the European Regional Development Fund (ERDF) has been used to set up or boost several hundred different financial instruments, of various shapes and sizes. Finnvera Loans, for example, uses ERDF support to assist development projects in western Finland, providing loans, guarantees

and venture capital. An ERDF investment of €2.8 million in Finnvera has contributed to a total fund of €16.4 million, enabling support to be provided to about 1 500 projects. In the southern Italian region of Calabria, €18.75 million from the European Social Fund (ESF) has been combined with finance from Fincalabria, the regional public financial institution, to create a total fund of €37.5 million, which provides micro-credit and guarantees for micro-credit. By January 2012, this financial instrument had supported around 1 300 entrepreneurs.

Different patterns are evident in the use of financial instruments by Member States. In general terms, wealthier EU countries that receive less cohesion funding per capita have typically shown a greater interest in financial instruments than grants. "The countries receiving lower resources have a tendency to be more selective in terms of the funding they provide. Financial instruments are seriously considered before making any decisions on the forms of financing," observes Mr Gonçalves.

Boosting small business

In terms of the objectives, he notes that: "up to now, financial instruments in cohesion policy have been applied to support small and medium-sized enterprises (SMEs), urban regeneration, urban renewal and energy efficiency." From a rural development point-of-view, the most relevant lessons are likely to come from the cohesion policy experience of using financial instruments to support SMEs.

"Up until December 2010, we estimated that there was approximately €8.1 billion



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of cohesion policy funding available to support SMEs [via financial instruments]," Mr Gonçalves adds. Support to SMEs is in fact the area in which cohesion policy financial instruments have had the most impact. "Support to SMEs, particularly through loans and guarantees, could be transposable to rural development, with the necessary adaptations."

Mr Gonçalves notes that cohesion policy is also "providing a lot of support in terms of risk capital for start-ups at an early stage. In the case of individual farmers, I don't think this would be replicable. But in terms of financing farming business or business set-ups it might be replicable. Perhaps for the transformation of an agricultural product, for example."

Getting it right

Mr Gonçalves puts forward three main lessons for rural development policy, based on the experience of the financial instruments for cohesion policy:

- financial instruments should be used to address a need;
- the provision of such instruments should be demand-driven; and
- the public policy interest should be carefully balanced with the interests of private sector fund managers.

Financial instruments, he says, should be used “where there is a real need and a real added value to their use. It is important to do a proper ex ante analysis of what the needs are, and why these needs are not being addressed by the market. So if a farmer goes to a bank and cannot get a loan, why is it? Is it because the bank is not interested because the farmer’s business is too small or is too high risk? If the bank is willing to give a loan, we should not displace it. We come in when the bank is not willing to give a loan, even though the project could be viable, despite its high risk. These are the areas we should cover with financial instruments supported with EU funds, be it in rural development or cohesion policy.”

In terms of ensuring that financial support is demand-driven, Mr Gonçalves says it is important to identify problems in the provision of finance and “design the financial instrument exactly to respond to that problem. There should be a good balance between what the needs are and how the market operates, and efforts should be made to try to adapt instruments to accepted market best practices.”

Cohesion policy has learned its own lessons in this respect. “One of the problems we faced in the past was that some instruments were created as supply-driven instruments, as if driven by the logic of, ‘we have the money, so why not create a financial instrument?’” explains the Head of Unit at DG Regio.

This approach offers the managers of public funds an easy and fast way to commit their funds, so they can say that they have done the job they were asked to do. However, this is not necessarily the best approach, since it does not provide the necessary assurance that public money is being used for the best possible purpose.

Hence, Mr Gonçalves notes that, “in future we should first analyse the problem, to identify where the need is, and how

we can address that need? The resources placed in financial instruments should be adapted to the identified investment requirements of an area.”

Financial instrument design also needs to take into account the special nature of EU funding. “We cannot forget that we are talking about taxpayers’ money, so we cannot do exactly the same things as a private investor might do,” he emphasises. “We have to introduce certain restrictions that normal market operators do not have, which makes the financing of risky ventures a very delicate matter, which needs careful research and follow-up supervision.”

This leads on to the third main lesson for Mr Gonçalves – that public policy interests should be balanced with those of fund managers. “Fund managers,” he remarks, “are there for profit, and we are there for public policy objectives - you have to find a way of aligning these interests so that by making profits the private investors are also serving public policy objectives.”

He summarises: “we provide funding for public policy objectives but we accept that the private investor needs to make a profit, otherwise they don’t come on board.”



Fine tuning

The Commission is refining its use of financial instruments for cohesion policy in the light of a report by the European Court of Auditors¹² (ECA), published in March 2012. The report recommended more robust assessments of the funding gap affecting SMEs that apply for support via financial instruments. It also identified a need to revise regulations to make them fit for the purposes of creating financial instruments, rather than just grant funding. Taking steps to use funds to leverage greater amounts of private investment was another key ECA recommendation. The issues spelt out by the report could provide further guidance for financial instruments in rural development policy.

On the subject of leveraging private investment (which is one of the main justifications for using financial instruments), Mr Gonçalves makes the point that, “the ECA clearly states that for guarantees, cohesion policy achieved a leverage that is as high or higher than any other type of financial instrument. In terms of equity, the leverage was lower but still respectable. In some cases the amount leveraged was up to three and a half times the EU contribution.”

On the use of loans to leverage private investment, he says that, “the European Court of Auditors mentions that up to €2 for each euro invested by the EU was achieved and that we could achieve a

much higher leverage. However, we have to take into account that we are working within the context of cohesion policy, engaging with diverse regions and providing support in areas of market failure.”

Mr Gonçalves adds that the ECA report has been taken into account in the proposals put forward by the European Commission for the 2014-2020 programming period. “The ECA also criticised the fact that the regulations were not adapted to financial instruments, so we tried to fill this gap, and the future regulations will have more detailed rules about the use of financial instruments.”

The road ahead

A Commission staff working document¹³, published in February 2012, provides a useful summary of the key issues and how the Commission will tackle them during the period 2014-2020. This will also be relevant to financial instruments used to promote rural development, as the Financial Regulation for 2014-2020 will set out common rules for the use of financial instruments in all policy areas financed by the EU budget.

The working document outlines a number of changes, including: financial instruments will be designed on the basis of ex-ante assessment that will identify market failures or shortcomings in financing; financial instruments can be combined with grants; ‘off-the-shelf’ standardised financial instruments will

be developed, according to pre-defined terms and conditions; rules pertaining to the management of funds are clarified; and the reporting of fund operations will be strengthened and streamlined.

The end result should be a situation in which cohesion funds and rural development funds can work side-by-side. “Clearly, within the programmes there are demarcations in terms of what actions can be supported, by the ERDF or the ESF on one side, and the rural development funds on the other. These delimitations will also be applicable to financial instruments,” says Mr Gonçalves.

Improvements to the system are welcome because financial instruments are clearly here to stay. Mr Gonçalves concludes that, “financial instruments will always be necessary, and are probably even more necessary now because we are in a situation of fiscal constraint. Budgets are becoming tighter and I don’t think this situation is going to alter after the current economic crisis. The process of fiscal consolidation will be maintained and, therefore, there will be less and less money available for grants and governments will be a lot more selective in terms of the grant money that is available. Therefore, economic activity that can potentially become self-financing should be supported through financial instruments and not through grants.”



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(12) Special Report No 2/2012, Financial instruments for SMEs co-financed by the European Regional Development Fund, available at <http://eca.europa.eu/portal/pls/portal/docs/1/13766742.PDF>

(13) SWD (2012) 36 final, Financial Instruments in Cohesion Policy, available at http://ec.europa.eu/regional_policy/sources/docoffic/official/communic/financial/financial_instruments_2012_en.pdf

Further online information sources:

Commission staff working document - Financial Instruments in Cohesion Policy

http://ec.europa.eu/regional_policy/sources/docoffic/official/communic/financial/financial_instruments_2012_en.pdf

Financial Engineering Instruments Implemented by Member States with ERDF Contributions. Synthesis Report

http://ec.europa.eu/regional_policy/thefunds/doc/instruments/financial/financial_engineering_report_2012.pdf

Annexes to the Synthesis Report on Financial Engineering Instruments Implemented by Member States with ERDF Contributions.

http://ec.europa.eu/regional_policy/thefunds/doc/instruments/financial/financial_engineering_annex_2012.zip

Factsheet: Financial Instruments in Cohesion Policy 2014-2020

http://ec.europa.eu/regional_policy/sources/docgener/informat/2014/financial_instruments_en.pdf

Designing micro-finance operations in the EU: A manual on how to build and implement micro-finance support programmes using the ESF

http://www.cop-ie.eu/sites/default/files/COPIE_ESFManual_Access_to_Finance_print.pdf



Sources of European investment support for rural financial instruments

A number of joint initiatives supported by the European Commission and the European Investment Bank (EIB) or the European Investment Fund (EIF) have relevance for rural Europe. These are partnerships between the European Commission's Directorate General for Regional Policy (DG REGIO) and a number of International Financial Institutions (IFIs), including the EIB group.

The EIF financial instruments include JEREMIE and JASMINE. The JEREMIE (Joint European Resources for Micro to Medium Enterprises) initiative is designed so that EIF support can complement EU cohesion policy. JEREMIE combines resources from the European Commission and the EIB, as well as funds from national public authorities and/or other financial institutions. JEREMIE's structure is unique, and it offers Member States the opportunity to use part of their Structural Funds to provide risk financing to SMEs by means of equity, loans and guarantees. This is done via a revolving 'Holding Fund', which acts as an umbrella fund. Flexibility in JEREMIE's structure allows for innovative financial engineering products that encourage micro-enterprises and SMEs (from rural and other areas) to move away from grant dependency, via a range of different financial solutions that are designed to fit their development needs.

JASMINE (Joint Action to Support Microfinance Institutions in Europe) is a technical assistance initiative for micro-finance institutions (MFI) in the EU. JASMINE uses finance from the European Commission and is managed by the EIF. Support through this instrument aims to expand the range and capacity of organisations that are involved in offering micro-finance to SMEs in the EU. It can be used by non-bank MFIs (including those eligible to access rural development co-finance) to help them scale-up their operations and maximise the impact of their micro-finance products on micro-enterprise development.

Joint European Commission/EIB initiatives include JASPERS and JESSICA. JASPERS ('Joint Assistance to Support Projects in European Regions') is a technical assistance partnership between the European Commission (DG Regional Policy), the EIB, the European Bank for Reconstruction and Development, and Germany's Kreditanstalt für Wiederaufbau (KfW). JASPERS provides assistance to help Member State authorities to undertake crucial preparatory work on large-scale development projects. Rural areas can benefit from JASPERS because its planning support helps to safeguard the quality of large projects, such as transport networks, energy grids and territorial regeneration plans. JASPERS operates in the 12 Member States that joined the EU since 2004, as well as in Croatia.

JESSICA (Joint European Support for Sustainable Investment in City Areas) previously focused on urban areas, but scope exists to extend its reach into some aspects of EU rural development policy. Referring to JESSICA's potential rural reach, an EIB spokesperson explains that, "for the 2014-2020 programming period of EU funding, an expansion of the scope and scale in the



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use of financial engineering instruments is foreseen, together with an enhancement of the flexibility of such instruments. In this context, scope could potentially arise for enhanced dialogue and exploration of partnership possibilities between JESSICA and vehicles for rural development, such as EU Rural Development Programme funds, especially in the fields of energy-related investments or the integration of food chains."

"JESSICA's remit still lies within the promotion of integrated solutions for sustainable urban development. A potential expansion of the programme's remit could envisage enhancing synergies between urban and rural areas (in terms of logistical infrastructure, fostering mobility and networking). However, such actions would have to be carefully designed and based on enabling legal bases. Potential integrated JESSICA actions in the field of carefully calibrated urban-rural partnerships would therefore be contingent on the delegation of specific competences by the national Managing Authorities to the EIB."

Another opportunity for closer ties between EU rural development policy and EU institutions like the EIB could arise in the form of a “development platform to promote capacity building and exchanges of experience between urban and rural areas». Such an initiative could potentially favour functional urban-rural exchanges. The Commission further proposes enhancing the use of financial engineering and technical assistance instruments and a more effective and efficient coordination of Structural and Cohesion Funds resources to maximise synergies. This is to be achieved by capitalising on ‘multi fund’ operational programmes and cross-financing capabilities at programme or operations level. In this context, the role of a new tool, the Integrated Territorial Investment (ITI), could be instrumental, as it allows for bundled funding from several priority axes of one or more operational programme. Results could thus deliver multi-dimensional and cross-sectoral interventions. Within such a context, it could potentially have relevance to the downstream financing of functional interventions into urban and neighbouring rural areas,” concludes the EIB spokesperson.

Further information can be found at:

- JEREMIE: http://www.eif.org/what_we_do/jeremie/index.htm
- JASMINE: http://www.eif.org/what_we_do/microfinance/JASMINE/index.htm
- JESSICA: <http://www.eib.org/jessica>
- JASPERS: <http://www.jaspers-europa-info.org>



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The role of National Rural Networks in facilitating access to finance

National Rural Networks (NRNs) are tasked with helping Member State authorities to improve the effectiveness of their Rural Development Programmes (RDPs). NRNs use a range of tools to analyse and promote good practice approaches to implementing RDPs and they are aware of the potential that financial instruments offer. The experience of Latvia's NRN highlights some useful steps that can be taken by NRNs to promote RDP financial instruments.

Amid the recent economic turmoil, it can be easy to forget that the EU country hit hardest by the 2008-2009 global financial crises was Latvia. Between 2008 and 2010, the Latvian economy contracted by a quarter, while the unemployment rate increased to about 23%. Many of those who remained in work also had to accept dramatic wage cuts.

One consequence of the crisis was that banks stopped lending to businesses, including farms and other enterprises in rural areas. Dzintars Vaivods, project manager for the Latvian National Rural

Network Support Unit, says that although the Latvian economy overall returned to growth in 2010, and has continued to recover from the crisis, the hangover from the economic downturn persists.

"There was a period when banks didn't provide any finance, even to very good projects," Mr Vaivods says. "The situation has since improved a lot, but banks are still hesitant, especially when it comes to small businesses." Restricted access to finance can hinder farm expansion projects, or plans to move into new areas of production. Other rural businesses also suffer. "Rural tourism companies are in

an even worse situation than farmers, because the last two to three years were not very good for this sector. Rural tourism is a sector that the banks don't finance at all," he adds.

Although rural businesses generally suffer from a lack of easy access to finance, and thus are limited in the investments they can make, some sub-sectors or types of enterprise struggle more than others. The biggest challenges, says Mr Vaivods, are faced by young farmers, new farmers who want to take over existing farms, smallholders and semi-subsistence farmers.

“There are some segments of farming where there is really a market failure,” he says. The reasons for this vary. Young farmers from the Baltic States and elsewhere in the EU, for example, find it difficult to get access to finance because they don’t have a track record or banking history and, in principle, represent a greater risk to the banks. Smallholders, meanwhile, suffer because “larger farms are always more stable and interesting for banks,” Mr Vaivods notes, adding that, “smallholders are under more intense market pressure and cannot compete with larger farms. Sometimes they have higher costs per unit of production, though not always”.

Rural enterprises can also suffer because banks are not sufficiently discerning when choosing who to lend money to. Returning to the issue of rural tourism, Mr Vaivods says that good businesses can sometimes lose out. “In rural tourism, the main problem is that there used to be many unsuccessful projects, and tourism was not an investment priority in the recession. But some rural tourism sites are well located and provide good services. Banks should, therefore, consider them in a more selective way.”

Bridging the gap

Where market failures persist, there is a potential role for RDP funds to provide support for financial instruments, in addition to the more traditional RDP grants. Mr Vaivods outlines a number of actions that could be taken to bridge the gap between rural enterprises’ need for finance to underpin their growth and the available supply of funds.

At the policy level, steps could be taken so that the segments of the rural economy that are under-served by the commercial banks are targeted with support. “The rural economy will benefit if there are more appropriate instruments providing support for smallholders and young farmers,” Mr Vaivods suggests. “We have RDP measures for young farmers and semi-subsistence farmers but often this is not enough.”

In particular, RDP measure 112 caps support for young farmers at €40 000. Often, more than this is needed, but banks are not filling the funding gap. Semi-subsistence farmers, support for whom is capped at €7 500, face similar difficulties.

Banks could be encouraged to be more active in lending to these segments of the farming community if guarantees, which could be backed by the RDP funds, were provided. In Latvia, a Loan Fund for farmers was set up in 2010 as a reaction to the economic and financial crisis, and this could be built on to also provide targeted guarantees.



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Mr Vaivods says that establishing the Latvian Loan Fund for farmers was a good idea. However, it has been slow to start working and, in the meantime, the Latvian economic situation has improved and banks have started to lend again, albeit cautiously. “The market situation is much better and the market could provide loans to farmers,” says Mr Vaivods. The Loan Fund could, therefore, be re-targeted, to concentrate on smallholders and new farmers. “The Fund is functioning, but can only provide partial support for these market segments,” he adds.

Some restructuring of RDP support could also be pursued. At present, young farmers can obtain a grant to cover 80% of their investment, and developed farms

can receive a grant that covers 40%. But for smallholders and semi-subsistence farmers, “there should be something in the middle,” Mr Vaivods suggests. If these farmers could get grants of 60% or 70%, it might be easier for them to obtain bank finance to fill the gaps.

More support could also be provided to agricultural exports. In Latvia, EU regional development funds provide backing for export support programmes, but agricultural agencies are not directly involved and agricultural exports are often overlooked.

Mr Vaivods believes that support for agricultural exports would be best concentrated on specific sectors. He gives the

example of cranberries. “Cranberries are one of our country’s niche products. We are one of the top five producers in the world. It is a good business, but capital intensive, and there are not many farms. It would be good if they could get some [export] support using financial instruments designed for this type of rural enterprise”.

For other agricultural exports, like grain or milk, finance is not the main issue. Rather, it is a question of improving co-operation, but there is some resistance to this in Latvia. “People still associate cooperation with the collectivisation from Soviet times, and they think it is not a good way to do business,” he says. “People prefer to work alone. I

think this is one of the biggest [rural development] challenges we face. Its solution may be a matter of generational change.”

Learning by doing

The financing of rural businesses is not just about banks extending loans or RDP funds providing guarantees, however. The Latvian NRN has realised that farmers and rural entrepreneurs need to be equipped with the necessary skills to obtain funding and work with financial institutions.

Hence, the Latvian NRN has set up specific training programmes for rural entrepreneurs. “If you have a loan you must cooperate with the bank, prepare a cash flow statement, make repayments on time, and so on,” says Mr Vaivods, adding that, “farmers must be prepared for this, and through the NRN we provide special financial management training”.

So far, two of these NRN training programmes have been put in place. The

first is for young people and is aimed at sparking their entrepreneurial creativity and reinforcing it through training. The programme starts with a two-day brainstorming session on ideas for rural businesses. Then, after decisions have been taken on which ideas to pursue, there is a follow-up course that concentrates on the preparation of a business plan. There is also a business plan competition, with prizes for the best proposals.

The second programme is aimed at semi-subsistence and young farmers. They also get input and advice on their business plans, plus a support package covering five years of ongoing advisory help. This is not mentoring, emphasises Mr Vaivods, it is rather aimed at keeping the farmer on track and ensuring that plans are carried through, for example by advising on farm restructuring.

Banks are involved in the NRN's training programmes, especially the young farmers' programme, and this helps to connect rural entrepreneurs with potential sources of finance. It is still early days,

but support has already been provided to about 400 farmers. “The training programmes are relatively new and we are still in the process of increasing their capacity,” explains Mr Vaivods.

He hopes that as the scheme develops, other NRNs might also become interested. “It is too early now to disseminate it to other countries,” he says, “but we have a very strong vision on this. We are learning by doing”.

The experience in rural Latvia underscore the fact that demand exists for rural financial instruments that are designed to meet funding gaps in the development of rural projects. NRNs can help to clarify and highlight the characteristics of such funding gaps. This process can inform the design, implementation and evaluation of new RDP financial instruments. Importantly, NRNs can also play a key role in building the business capacity of entrepreneurs in rural areas, helping them to make good use of RDP funds.



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Financial instruments under the NRRN Rural Entrepreneurship Thematic Initiative



National Rural Networks (NRNs) from around Europe have joined forces to exchange experience and identify transferable solutions to facilitate improved access to financial assistance for rural businesses. This work is taking place within the framework of an NRN Thematic Initiative on Rural Entrepreneurship, which was set up in response to the global economic crisis.

The European Network for Rural Development (ENRD) set up an NRN Thematic Initiative on Rural Entrepreneurship in March 2010. During the early stages 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.

NRNs decided that work related to the theme of 'Overcoming Obstacles to Entrepreneurship' would concentrate on investigating how rural entrepreneurs access capital. During the 11th NRN meeting, in April 2011, discussions focused on the issues related to the lack of credit facilities and finance in relation to rural development initiatives. The Swedish NRN took the lead on this

topic and formed a 'Rural Finance Task Force' (RFTF), which includes NRN members from Latvia, Finland, Italy, Hungary, Germany and France.

Four main tasks were identified for further elaboration by the RFTF, namely:

- collating examples of active financial engineering instruments in the EU;
- facilitating training on financial engineering instruments for rural entrepreneurs, the financial sector and the public sector;
- raising awareness about the financial engineering potential of the EAFRD and also the role of other sources of funding; and
- agreeing a common language and a rating mechanism for rural investment proposals.

To date, much of the RFTF's work has focused on the collection of information about how financial instruments support rural enterprises in the EU. Interim findings identified relevant material and helped to clarify the current state-of-play and further research is underway to identify new case studies on rural financial instruments.

The ENRD Contact Point also surveyed Managing Authorities, Paying Agencies and financial institutions to understand better the factors that influence the uptake of financial engineering in RDPs, and the criteria used by banks in assessing the risk of projects in rural areas where such schemes have been activated. In addition, NRNs contributed by sourcing further examples of credit schemes operating in their respective countries. All this information, in addition to an extensive literature review, was synthesised in a final report¹⁴, which was presented during the 14th NRN Meeting in Thessaloniki, Greece, in February 2012¹⁵.

The ENRD also supported a seminar on, 'Facilitating access to finance for rural micro-enterprises', which was organised by the Latvian NRN in Riga (June 2012)¹⁶. During this seminar a number of case studies identified by the NRNs were presented.

One of the case studies featured a successful micro-credit scheme from Latvia, which has achieved some impressive results in assisting the development needs of small businesses run by women.

(14) http://enrd.ec.europa.eu/app_templates/filedownload.cfm?id=E6109191-9B8E-3ACA-BE4F-780D87307DC1

(15) http://enrd.ec.europa.eu/en-rd-events-and-meetings/meetings/en/14th-nrn-meeting_en.cfm

(16) See the Latvian NRN website for copies of the Seminar presentations and programme at http://www.laukutikls.lv/citi_pasakumi/3122-veiksmigi_aizvadits_starptautisks_seminars_finansejuma_piekluves_atvieglosana_lauku_uznemumiem

A Latvian micro-credit scheme for rural women

Micro-credit schemes are a type of financial instrument, used in developed and developing countries for making small loans available to new entrepreneurs. These schemes traditionally target people who are excluded from mainstream financial services and the micro-credit option provides them with a chance to get the start they need. Micro-credit instruments are often designed specifically to meet the particular needs and circumstances of a defined target group.

Loans from micro-credit schemes are usually short-term, with the loan duration commonly lasting less than a year. Finance is provided to cover working capital, and payments can normally be received immediately after approval of the loan. Repayments are commonly made on a weekly or monthly basis. Amounts offered by micro-credit schemes are usually relatively small (below €1 000). Borrowers typically start with smaller loans and as they repay these loans they demonstrate their creditworthiness, thus becoming eligible for larger loans.

A micro-credit scheme using this approach has been operating successfully in Latvia since 1998. This financial instrument provides loans to female entrepreneurs and is managed by the Latvian Rural Women's Association. Maiga Krūzmētra from the scheme explains its background: "after our independence from the Soviet Union, people had to find new ways of earning an income and the general public did not have much business experience. We had business ideas and ambition but many people did not know how to take their ideas forward."

"One of the big obstacles was people's lack of experience in dealing with banks and getting loans. There was a worry that the banks were powerful institutions that would not want to support small-scale business proposals from the countryside. Rural women thought it would be even more difficult for them to get financial help from a bank, so they were even less inclined to think about setting up their own business, despite often having some good ideas."

This social exclusion issue came to the attention of the Nordic Council of Ministers, which was involved in supporting the Baltic States' transition to a market economy. The Council members were aware of the effectiveness of micro-credit schemes, not only for stimulating local economic development, but also as a tool for boosting the confidence of women and encouraging them to become more active in the development of their regions.



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Funding was awarded from the Nordic Council of Ministers for a pilot micro-credit scheme, which has now grown into a network of over 70 micro-credit groups around rural Latvia. Ms Krūzmētra explains: "we have had a lot of success with using this type of small-scale Loan Fund, and we have helped women develop a wide variety of local businesses that provide jobs and services that are welcome in their local areas. Beneficiaries of the micro-credits have included younger and older people and their rural business projects include hairdressing, vegetable growing, herbal teas, tourism and sewing services, to name just a few."

The Latvian scheme works the same way as most micro-credit instruments. Loan applicants do not need to have physical collateral such as property. Instead the system uses a collective guarantee, whereby anyone who takes out a loan joins the micro-credit group and everyone in the group shares the risks taken by the group. This approach - based on solidarity - proves attractive and it means that members of the scheme are mutually responsible for ensuring that their individual loans are repaid. In some instances, borrowers can be asked to provide one or two personal guarantors, such as friends, neighbours or local community leaders.

"We find that women are more willing to think about taking a loan if they feel that they have the support of other women in the group," remarks Ms Krūzmētra. "Another important success factor for our Loan Fund is the business mentoring support that we provide as part of the overall business development package. This capacity building approach has been welcomed by our clients who tell us that the advice we give about financial management and other business skills is very useful. The mentoring increases their confidence and helps reduce the risk of businesses failing. It also helps to protect the Loan Fund and the members of the group from default risks. It is certainly part of the reason why we have had such a very low default rate on the micro-credits we provide."

"In addition to money from the Nordic Council of Ministers we have also received EU funds from INTERREG to help expand the scheme. We now also have funds from a bank here in Latvia, as well as from our Association's *Fund for the Entrepreneurship of Rural Women in Latvia*. The money is well used and we can see the difference it has made to both the business confidence of rural women and local economic development. More than 130 women have received micro-credits from our scheme, and for the majority of women this was their first loan."

"We encourage our clients to take a step-by-step approach to their business development. A good example of what this can lead to is shown by Gunta Čepuka, from the Bauskas district. In 2006, she received a loan to help set up a small farming enterprise. She then took out another micro-credit to help store manure from her livestock. The success of her food production gave her the idea and confidence to open a farm shop, selling products from local farmers. Her latest loan from the scheme has helped her to build a facility for smoking meat, which adds value to local agricultural products."

"In addition to added value projects like Gunta's, our micro-credit instrument also creates employment. Biruta Mežale from Cēsis for instance became a member of one of our micro-credit groups to help establish her local accountancy business. She provides individual accounting services to local enterprises and her business has now grown to employ eight people, servicing over 100 clients."

"I am very pleased with the achievements of our micro-credit financial instrument and I think this sort of financial assistance could be useful in many other parts of Europe. It allows rural women to start business activities and gives them an opportunity to gain experience and self-confidence with the support of other group members. The benefits of such an approach are not always possible when using other financial instruments."



ENRD Coordination Committee workshop

The ENRD Coordination Committee workshop on 'Financial Engineering' in October 2012 will focus on the activities of the RFTF. This large-scale workshop aims to bring together around 160 different RDP stakeholders from around the EU to explore the issues involved in increasing the uptake of financial instruments in future RDPs. A discussion on the new rules for the next programming period and how to better evaluate the market needs during the ex-ante assessment are some of the issues that will be tackled.

On-going priorities

A number of ongoing actions by the NRNs and ENRD, under the RFTF, aim to feed into the process of designing the new RDPs for 2014-2020. More exchanges of experience on the utilisation of various financial engineering instruments are foreseen as part of this process, and proposals have also been made to develop methodological guidelines on both the assessment of rural financing gaps and the other procedures involved in operating financial instruments, which can assist Managing Authorities and Paying Agencies in running such schemes.

NRNs are being encouraged to start working closely with Managing Authorities in order to prepare for the introduction of financial engineering instruments under the CSF, and to provide information on alternative means of improving access to finance for rural SMEs.

A checklist has been designed to provide a useful guide for RDP Managing Authorities, intermediary bodies and other stakeholders involved in supervising the EAFRD.

Useful web links

Locate banks, venture capital funds and other organisations in your country that provide funding through financial instruments on the Access2Finance website (<http://www.access2finance.eu/>)

The European Union's grants website (http://ec.europa.eu/contracts_grants/grants_en.htm)

The Enterprise Europe Network (<http://portal.enterprise-europe-network.ec.europa.eu/>)

Member organisations of the Enterprise Europe Network in 50 countries (<http://portal.enterprise-europe-network.ec.europa.eu/about/branches>)

Links to EAFRD Managing Authorities in the EU Member States (http://ec.europa.eu/agriculture/links-to-ministries/index_en.htm)

Locate national/regional Managing Authorities that can inform you about obtaining financing in your country or region via the EU Structural Funds (http://ec.europa.eu/regional_policy/manage/authority/authority_en.cfm)

Choosing the right Financial Instrument

Selecting the right type of financial instrument to help fill the rural SMEs financing gap requires careful analysis and planning, and consideration of the following points.

- All proposals for financial engineering measures must be duly justified by an assessment of the level of demand and the specific needs of the target beneficiaries (SME and/or other organisations). Analyses of financing shortfalls should be of high quality and include a quantified analysis of the financing gap.
- When approving RDPs that include financial engineering measures, the European Commission should verify their consistency with the characteristics of the financing gap and ensure that the assessment and proposed measures are in line.
- An appropriate level of demand is required to avoid public funds being 'geographically scattered' by financial instruments. Providing access to finance with fund sizes below a certain critical mass is very likely to be inefficient and unsustainable. This is because the overhead costs and the risks associated with investments or loans cannot be spread over a sufficient number of SMEs. RDP authorities should avoid situations where the combined risk profile and the small fund size can actually put the entire fund portfolio at risk (because of an insufficient diversification of the risk taken by the fund).
- All proposals for financial engineering measures must include contractually binding minimum leverage ratios, minimum revolving periods¹⁷ and data for the calculation of leverage indicators.
- Every financial instrument requires a reliable and technically robust monitoring and evaluation (M&E) system, capable of accurately informing the RDP's reporting and auditing processes. The M&E system must be able to distinguish each financial instrument and segregate its results or outcomes from conventional grants. The amount of money actually paid to an SMEs should be transparent. A small number of measurable, relevant, specific and uniform M&E indicators should be agreed in advance for all financial instruments.
- Arrangements for covering the management costs of financial instruments should be transparent, auditable and compliant with the criteria set out in the regulations.
- Any preferential treatment for private sector contributors to a financial instrument (over the public sector contributors) must be carefully justified, as this may restrict the capacity to generate sufficient legacy funding for the next wave of rural SMEs.
- Working capital eligibility should be examined on a case-by-case basis, taking into account applicable State aid legislation and rules.
- 'Evergreen'¹⁸ revolving fund approaches should be favoured, to ensure that financial instruments have a long-term legacy. Conditions should be set that prevent legacy funds being used for any purpose other than the original rural development objective of the RDP measure from which the EAFRD co-finance was sourced.

(17) A revolving period refers to the facility provided to a borrower with a maximum aggregate amount of capital, available over a specified period of time

(18) An Evergreen Fund is a financial instrument in which the returns that are generated on investments are automatically returned to the overall Fund budget, in order to sustain a continuous supply of available capital for investments.



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Glossary of key terms used in this issue of Rural Review

Common Strategic Framework	An EU policy framework proposing common and consistent implementation rules for EU Funds under shared management.
Equity Fund	An instrument providing investment support to a business (existing or start-up) via the acquisition of an equity stake (part-ownership).
Evergreen Fund	An Evergreen Fund is a financial instrument in which the returns that are generated on investments are automatically returned to the overall fund budget, in order to sustain a continuous supply of available capital for investments.
Grant Fund	A form of financial assistance to a beneficiary that does not need to be repaid (other than for contractual infringement reasons).
Guarantee Fund	An instrument providing investment support to a business via guarantees. A guarantee is a commitment by a third party, called the guarantor, to pay the debt of a borrower when the latter cannot pay it. The guarantor is liable to cover any shortfall or default on the borrower's debt under the terms and conditions as stipulated in the agreement between the guarantor, the lender and/or the borrower.
Holding Fund	Fund set up to invest in one or more financial instruments. Holding funds can be considered to be beneficiaries of EU support.
Interest Rate Subsidy scheme	Interest Rate Subsidies are a means of supporting the payment of interest rates on loans.
Legacy resources	Capital resources and gains, and other earnings or yields attributable to support from the EU Funds to financial instruments.
Loan Fund	An instrument providing investment support to a business via a loan. A loan is a type of debt. In a loan, the borrower initially receives or borrows an amount of money, called the principal, from the lender, and is obligated to pay back an equal amount of money to the lender at a later time. Typically, the money is paid back in regular instalments, or partial repayments; in an annuity, each instalment is the same amount. A loan is generally provided at a cost, referred to as interest on the debt.
Managing Authority	A Managing Authority is designated by the Member State as the body responsible for the management of an EU co-funded programme, such as a Rural Development Programme. It may be a public or private body.
Market failure	An economic situation where the quantity of a product demanded by consumers does not match the quantity supplied by suppliers. This is caused by various factors, which prevent supply meeting demand.
Micro-business	Businesses with less than 10 employees and an annual turnover under €2 million.
Micro-credit	Small loans, usually up to €25,000, granted either by institutions specialising in microcredit or by other financial intermediaries. In the context of this publication, the purpose of the micro-credit needs to be related to economic activity.
Risk assessment	Risk assessment is a step in a risk management procedure and relates to the determination of the quantitative or qualitative value of the credit risk ('valuation'). This exercise is specifically (but not only) relevant for the issuing of guarantees. Quantitative credit risk assessment requires the estimation and calculation of risk (including 'expected loss' and 'unexpected loss'): the magnitude of the potential loss and the probability that the loss will occur.
Rural financing gap	The gap that exists between the availability of financial support for rural business and the support they need for their development.
Seed Capital	Seed Capital is financing provided to study, assess and develop an initial business concept. The seed phase precedes the start-up phase. The two phases together are often called the early stage.
Start-up Capital	Start-up Capital is provided to enterprises for product development and initial marketing. Enterprises may be in the process of being set up or may already exist but have yet to sell their product or service commercially.
Small and Medium-sized Enterprise	Businesses with between 10-250 employees and an annual turnover of between €2 million and €50 million.
Structural Funds	Instruments of EU Cohesion policy, aimed at reducing regional disparities. Include the European Regional Development Fund and the European Social Fund.
Venture Capital Fund	An instrument providing investment support to a business via Venture Capital (VC). VC is a type of private equity support, normally used to fund an early-stage (seed and start-up) or expanding business. Higher risks are associated with early stage businesses so to offset this the VC Fund will generally seek a higher-than-average return on investment.
Winding up	A process that entails selling all the assets of a Fund, paying off creditors, distributing any remaining assets to the principals, and then dissolving the fund. Essentially, 'winding up' is to be understood as 'liquidation'.
Working capital	Working capital relates to the liquid assets an enterprise has available to build its business, but is also a measure of its efficiency and financial health. Working capital can be positive or negative, depending on how much short-term debt the company is carrying. A negative working capital means that a company currently is unable to meet its short-term liabilities with cash, accounts receivable, and inventory. Working capital is calculated as: current assets minus current liabilities.

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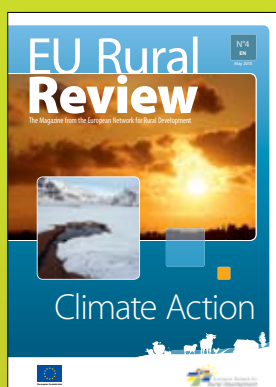
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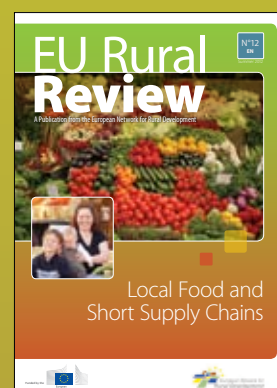
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