fi compass EAFRD

Using financial instruments to reduce the impact of price volatility in agriculture

European Commission

European Investment Bank The EU bank

DISCLAIMER

This publication describes the possibilities of flexible financial support for EU farmers under the European Agricultural Fund for Rural Development (EAFRD). This approach may help farmers to respond adequately to the negative financial impact from price volatility and/or unexpected changes in market conditions.

Financial instruments are a suitable delivery mode to provide tailored support: with their possibility for an appropriate mix of public and private resources, they are a unique tool for the managing authorities to use EAFRD in cooperation with the financial sector to achieve high impact.

This document is developed on an informative basis and it does not represent the official position of either the European Commission, EIB Group or any of its services.

Glossary and definitions

Expression	Explanation
CAP	Common Agricultural Policy
DG AGRI	Directorate General for Agriculture and Rural Development
EAFRD	European Agricultural Fund for Rural Development
EIB	European Investment Bank
EIF	European Investment Fund
RDP	Rural Development Programme

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What is it about?

The European Agricultural Fund for Rural Development (EAFRD) allows managing authorities to set-up a wide range of potential financial instrument structures to support EU farmers.

The purpose of this document is to equip EAFRD managing authorities with ideas on how to strengthen the support they give to farmers through EAFRD financial instruments when market conditions cause uncertainties or price fluctuations. It is based on evidence from real practices applied across the EU combined with the possibilities offered by the EAFRD rules.

It also aims to inspire financial intermediaries, which finance agriculture and do already offer, or are willing to develop, flexible financial schemes for the agricultural sector.

It gives insights to farm stakeholders on what they could negotiate when approaching financial intermediaries for financing.

What do we offer?

We encourage all EAFRD managing authorities to investigate the possibilities for setting up flexible loan conditions in their financial instruments to ease the potential financial impact of market volatilities on the farmer and to facilitate a market oriented risk behaviour of the farmer.

The ambition of European Commission Directorate General for Agriculture and Rural Development (DG AGRI), together with the European Investment Bank (EIB) *fi-compass* advisory platform is to now raise awareness of these possibilities and support through tailored advice an initial number of managing authorities and banking intermediaries. The experience and lessons learnt may then be used to streamline the process further and thereby expand its usage in the post 2020 Common Agricultural Policy (CAP) Strategic Plans.

For those EAFRD managing authorities requiring **tailored advice**, based on bilateral agreements, which can be paid for using their EAFRD technical assistance budgets, EIB Advisory Services (AS) is:

- providing advisory support;
- developing investment strategies and fund structures; and
- preparing the managing authorities for the selection of financial intermediaries.

Why are flexible financial products needed to support the agricultural sector in the EU?

Agricultural markets are characterised by fast changing market dynamics and high price fluctuations, as a result, farmers are often confronted with substantial changes in the prices they receive for their goods or the prices they have to pay for the primary input.

The uncertainty about the development of the future income caused by this price volatility can lead to sub-optimal investment decisions, if insurance[1] or risk mitigation is non-existent or is highly priced. Accordingly, as expectations of future stable cash flows are substantial for the financial planning of the medium- and long-term investments, there is a need to support farmers in mitigating the potential financial impact of market price volatility. Indeed, this price volatility can lead to temporary financial difficulties for otherwise generally fully viable farms.

1 The hedging of the primary risk, i.e. changes in prices and/or unexpected events affecting the market conditions, is traditionally not part of financing institutions' business activities but offered by insurance companies or enterprises active in commodity trading. This is as the risk of assessment approach is not based on the (financial and credit) characteristics of a farmer as borrower, but on the likelihood of the occurrence of well-defined events or movements of prices for standardised goods and products.

Farmers seeking financing and financial institutions providing it can both benefit from financial products, which incorporate sufficient flexibility in their terms to withstand the consequences of incurred market price volatility: flexible financial products.

Price volatility in the agricultural sector

The concept of price volatility describes how frequently the prices of (agricultural) products change over time, both upwards (increases) and downwards (decreases).

While some variation in prices is considered to be a normal aspect of well-functioning markets, volatility becomes problematic when price movements are large and unpredictable.

There are many factors, which explain the overall higher level of price volatility in the agricultural sector compared to other economic sectors. In the short-term, because the market fundamentals of supply and demand are inflexible: demand is rather fixed because food is a basic human necessity, while supply is unable to adapt quickly because food takes time to be produced.

There are also macro-economic factors, such as exchange rates and oil prices, which can also have a substantial influence on food prices. Adverse climate and weather factors and plant or animal diseases can have a significant impact on seasonal agricultural output.

Changes in agricultural and trade policies can also increase price volatility and its consequences for farmers as well as trade restrictions imposed by governments.

Can a financial instrument be set-up only when unexpected events happen? Or can it be set-up on a stand-by basis ?

The timeframe for the set-up of a financial instrument can be estimated to be at least six months to one year. Accordingly, support through a financial instrument may reach the farmer too late if action is taken by the managing authority only after an unexpected event impacting the agricultural sector.

What is 'flexibility' in financial products?

In lending products offered by financial intermediaries, there is flexibility when repayments for the borrower can vary during the reimbursement period according to conditions and criteria agreed ex-ante (i.e. at the signature of the loan contract) through a modification of the repayment schedule. Flexible loan products can for example include for a limited period of time:

- Full suspension of the repayment (capital and interest); or
- Total or partial suspension of the capital repayment (e.g. interest only or grace periods) to lower the initially agreed periodical debt service/instalments.

The unpaid amounts will then be reimbursed through an extension of the loan maturity maintaining the original debt service/instalments or by increasing the amount of the remaining instalments.

Example(1) of 'flexible' product already available:

Dairy Farm Expansion Loan Scheme

The Ulster Bank in Ireland has developed a product to help farmers coping with the extreme seasonal milk production pattern and the cyclical milk price variations: the 'Dairy Farm Expansion Loan Scheme'.

Financing under this loan for dairy farm investments can reach up to EUR 2m with a fixed or variable interest rate and maturities of up to 20 years for land purchase, 15 years for buildings and 5 years for infrastructure and machinery.

The flexibility can be activated at any time, i.e. the farmer can choose to increase the repayments in months with high milk sale or to pay interest only for a period of up to 24 months according to its needs to cope with the cyclical milk production in Ireland.

Flexibility could be requested by the borrower or it could be automatically linked (by the intermediary) to the variation of market prices or other indicators.

Do flexible financial products already exist?

A recent *fi-compass* study, 'Flexible financial products for the agricultural sector in the EU', has investigated the availability on the market and the interest of financial intermediaries for loan products with flexible repayment schedules in the EU.

Based on the screening of the offering of 216 financial intermediaries in the EU, the research has collected more than 20 examples of flexible financial products.

Current products are normally simple and have an option for the borrower to ask for modification of the repayment schedule.

The level of flexibility varies from, products where a complete suspension of instalments is possible for a limited period (e.g. 12 months) to ones where only the repayment of principle can be suspended. In addition, while a few products allow for an extension of maturity, many just spread the unpaid amount over the remaining instalments. This implies a bigger impact on enterprise cash flow once the grace period ends.

Example(2) of 'flexible' product already available:

KBC Agroflex Credit

The 'KBC Agroflex Credit' is offered by KBC Bank in Belgium and allows for suspension of capital repayment terms for farmers with temporary financial difficulties caused by diseases, pests, storms, prolonged drought, collapsing prices and similar setbacks.

The loan finances investments with maturities of up to 20 years and is available to farmers of all sectors and regardless of farm size or activity volume.

Another important aspect is linked to the discretionary power of a bank in allowing activation of the flexibility clauses. While a few products seem to include an option for the borrower to activate the flexible clauses without any specific justification, a bank can normally ask for evidence or documentation to substantiate the request.

Best practices among current products include the:

- option to suspend instalments for a limited period without specific justification;
- possibility of suspending the entire instalment;
- possibility to extend the loan duration to avoid high instalments after the suspension; and
- absence of any additional fee for activation of a flexibility clause.

Interviews conducted for the study show that financial intermediaries see the need for flexibility in financial products for agricultural enterprises, justified by agricultural production specificities.

The vast majority of interviewed financial intermediaries see a need for public support to provide flexible products. Public support might be used to stimulate additional intermediaries to offer such products and at the same time to improve the conditions on existing flexible loans.

The characteristics found in current best practices, may serve as a reference for financial instruments aiming to promote flexible financial products for agricultural enterprises.

Example(3) of 'flexible' product already available:

Union Business Loan

In Poland, GBS Bank offers a 'Union Business Loan' not only exclusively to the agricultural sector but also to all other sectors.

It is available to finance investments in existing and new businesses for up to 10 years. The loan terms offer full flexibility to align the repayment obligations with the seasonal income variations. In detail, the loan duration can either be shortened or extended and the repayment schedule can be changed in amounts and frequency.

What is the added value of a financial instrument?

Generally, managing authorities can use financial instruments as a delivery tool under their Rural Development Programme (RDP) or CAP Strategic Plans, also in combination with grant supports, to complement and diversify their support options to the agricultural sector. The added value of a financial instrument, compared to a grants-only form of support, is that financial instruments can:

1. Have a greater impact (leverage effect);
2. Enhance the efficient use of the resources (revolving nature); and
3. Incentivise the final recipient to greater financial discipline and (potentially) increased financial profitability of the investments as the funds are repayable.

In general, any intervention through an EAFRD financial instrument shall result in some form a 'financial benefit' for the farmer compared to conventional financing without EAFRD intervention. This financial benefit can take various forms:

1. Lower interest rates;
2. Reduced collateral requirements;
3. Longer maturities; and/or
4. Other loan characteristics improving the financing conditions.

Why are financial instruments suitable choice for managing authorities, financial institutions and for farmers?

Managing authorities

Financial instruments offer important benefits for managing authorities to support farmers in a market context characterised by significant constraints in the access to not only flexible credit products for farmers, but to credit itself. The managing authority can join forces with the private financial sector and support financially viable investments through loans with an additional financial benefit for the final recipients.

Financial intermediaries

Financial Intermediaries can benefit from financial instruments as a starting point to get closer to the agricultural sector by providing access to a targeted range of financial products with a contained risk horizon compared to standard business. It is an opportunity to develop financing structures that are more adapted to the particular risks associated with agriculture, as it is for price volatility risk.

Farmers

In addition to its contribution to the mitigation of the financial impact of price volatility as presented here, financial instruments can also benefit to farmers lacking (i) credit history in general, (ii) sufficient collateral (e.g. young farmers), (iii) accurate and reliable financial statements (i.e. small agricultural enterprises, natural persons), or (iv) starting new activities and/or diversification activities. Another fundamental advantage of this approach to farmers is that they can get the funding upfront, which is crucial for start-ups.

It is recalled that financial instruments offering flexible loan conditions can be developed to suit all agricultural businesses, ranging from small-scale individual farmers to larger agricultural entrepreneurs, co-operatives and other forms of businesses operating in the sector.

How can financial instruments contribute to the development of flexible financial products?

Financial instruments offer credit risk protection and/or liquidity to financial institutions, which in exchange are requested to transfer the overall benefit to the final recipients (i.e. farmers). This is expected to be translated, as mentioned above, in more favourable conditions in terms (e.g. reduced interest rate, reduced collateral requirement or longer maturity). The terms and obligations of the use of EAFRD by the financial intermediaries are regulated in the funding agreement between the managing authority and the financial intermediaries.

A **financial instrument** can also constitute the basis for cooperation between managing authorities and financial institutions to develop innovative loan products, which **can be flexible enough** to **cater for the financial impact of price volatility on the farmer's overall financial situation**. More concretely, the **funding agreement can set appropriate incentives for the financial institutions** to provide **final recipients** with **additional advantages in terms of increased flexibility in the repayment schedule**.

It is important to note, that the lending terms and conditions set out in the funding agreement, including possible flexibility in the repayment, need to reflect the actual market conditions of the programming area. This includes, inter alia, interest rate level, specific sector risk, structure of the market supply (e.g. number of financial institutions, level of competition etc.). One possibility to ensure that more favourable lending conditions, including in terms of flexibility in the repayment, are concretely transferred to the final recipients is to select through an open procedure the financial institutions, which will participate to the financial instrument.

Offered terms and conditions for lending are included in the award criteria for the selection, stimulating competition among banks interested in the benefit of the financial instrument. This will ensure that the borrowers will obtain from the financial instrument the best possible conditions according to the specificities of the relevant sector and geography.

Example(4) of 'flexible' product already available:

Modul'Agri

In France, Crédit Mutuel offers 'Modul'Agri' investment loans for new buildings, upgrades of immovable assets or other investments with maturities of up to 15 years and covering up to 100% of the investment cost. The loan is available to all farmers with a special focus on wine growers as they can limit financial pressure caused by the difficulties of forecasting the expected harvest and prices.

What are the major steps to implement a financial instrument including flexible mechanisms?

Ex-ante assessment

- Mandatory ex-ante assessment to confirm the financing gap and need for intervention;
- Analysis of available flexible products and potential for new flexible products; and
- Analysis and recommendation for type of financial instrument.

RDP or CAP Strategic Plan

- Identifies the priority or measure from which contribution is provided; and
- Submission to and approval by European Commission.

Definition of financial instrument and start of selection process for financial intermediaries

- Selection of one or more financial intermediaries through an open call for expression of interest according to their experience, financial capacity and other criteria to implement the financial instrument; and
- Definition of mechanism to transfer the benefit, i.e. the flexibility, to final recipients included in the selection process.

Signature of the funding agreement

- Between the managing authority and the financial intermediary.

Implementation of financial instrument

- Financial intermediary develops flexible products in line with the terms and conditions established in the funding agreement.

Loans to farmers

- Farmers can approach the financial intermediary and request the flexible loan offered by the financial intermediary.

What are the possibilities that a financial instrument offers to combine different forms of support?

An EAFRD financial instrument does not only allow for financial products available to farmers serving different financing purposes, i.e. combining investment loans and working capital loans with continuous availability as a general financing resource, but the investment component can also be enhanced through a grant. In detail, the investment loan component could finance eligible investments to final recipients on a flexible basis in combination with a separate grant support.

A working capital component could serve other purposes and be available for investments needed for recovery from a crisis event or to address short liquidity difficulties. It is recalled that the joint support has to respect the maximum aid intensity.

For the post-2020 period, the European Commission has proposed that EAFRD financial instruments will also be able to support working capital finance not linked to investment operations including when supported by a grant.

Which types of financial instrument structures are existing and what is the most suitable type?

Principally, there are two instruments available for the implementation of EAFRD financial instruments with financial intermediaries (please see the Annex for a more detailed explanation). The EAFRD is used as follows:

- For a guarantee instrument, the EAFRD is placed in a dedicated fund and used to provide a guarantee on the loans of the financial intermediaries to the farmers; or
- For a loan instrument, the EAFRD is transferred to a financial intermediary, which pools these resources with its own funds.

The choice between the two instruments depends on the market conditions and the objectives of the managing authority. It should be based in particular on the indications of the ex-ante assessment for the use of financial instruments, with reference to the dimension and nature of the financing gap potentially identified.

The guarantee instrument can provide an effective support to help tackle risk aversion from the banks, particularly for specific categories of enterprises, which lack sufficient collateral, such as young farmers. At the same time, this type of instrument does not provide liquidity to the banks (i.e. banks provide loans with their own funds, whereas RDP funds are set aside to be used in case of any default happens).

If banks struggle to find the provision of funding to provide loans to enterprises (e.g. in case of financial crisis), a loan instrument might be the most appropriate tool. The risk-sharing loan instrument illustrated in the Annex provides liquidity and risk protection, since the risk for the RDP resources is retained by the managing authority. In this sense, it can offer the advantages provided by a guarantee fund. In addition, this instrument offers a higher reduction on the interest rate compared to the guarantee (i.e. allows the managing authority to provide loans at a more favourable interest rate).

The disadvantage of the loan fund structure is that it absorbs a higher amount of public resources, as compared to the guarantee structure. Guarantee instruments can in fact be considered in general more efficient since they offer higher leverage (i.e. amount of resources that reach the final recipients for each euro of RDP committed resources).

TECHNICAL ANNEX

This technical annex describes in detail two of the most common implementation structures for EAFRD financial instruments:

- Funded risk sharing loan instrument; and
- Guarantee instrument.

In essence, both structures reduce the potential losses for a financial intermediary following the default of loans to final recipients. Although the loans do benefit from such a risk coverage, the identification, selection, assessment and provision of the loans to final recipients has to be performed by the financial intermediary in accordance with its standard procedures and in accordance with the principles set out in the relevant funding agreement. The financial intermediary has to implement a consistent lending policy, especially regarding portfolio diversification, enabling a sound credit portfolio management and risk diversification, while complying with the applicable industry standards, and at the same time remaining aligned with the managing authority's policy objectives.

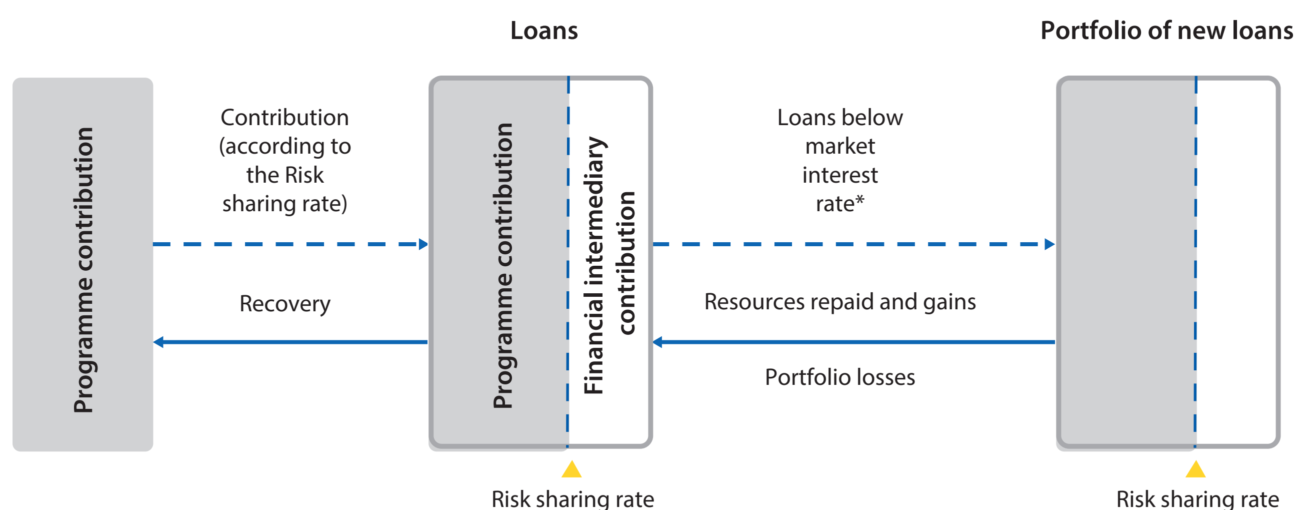
The main differences between the two structures are i) the Funded risk sharing loan instrument provides liquidity and risk protection to the banks whereas the Guarantee instrument provides risk protection only, and ii) the Guarantee instrument can allow for a higher impact of the EAFRD in terms of risk protection on loans to final recipients (i.e. leverage).

A) Funded risk sharing loan instrument

In this structure, a dedicated loan fund is established by the financial intermediary using the EAFRD together with a portion of its own funds to generate a new portfolio of loans within a pre-determined limited period of time.

From a risk perspective, each loan (see figure below) will be constituted by a public component (EAFRD contribution) and a private one (financial intermediary's resources).

Figure 1: Funded risk sharing loan instrument



The risk on the public component of the loan is retained by the managing authority, reducing the financial losses in case of default. This reduced risk cost is then to be used to provide flexibility and has to translate into the loan characteristics (e.g. suspension of interest payments, extension of maturity) agreed in the funding agreement. To ensure the agreement is respected, financial intermediary is required to demonstrate that it uses a product policy to ensure the transfer of the full financial benefit to the eligible final recipients.

Although the managing authority retains the risk of default on the public component of each loan, the financial intermediary is requested to take recovery actions in relation to the entire amount of each defaulted loan in accordance with its internal guidelines and procedures. Amounts recovered (net of recovery and foreclosure costs, if any) shall be allocated pro rata to the risk sharing between the financial intermediary and the managing authority.

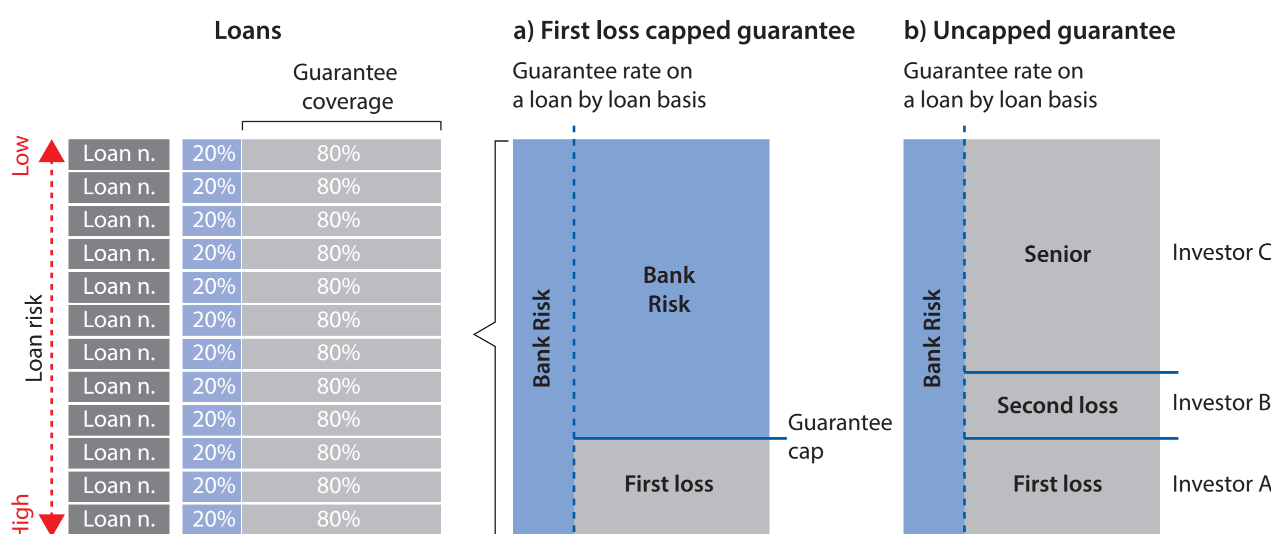
B) Guarantee instrument

In a guarantee instrument, the EAFRD contribution is placed in a dedicated fund to provide guarantees to eligible loans issued by financial institutions (banks). Contrary to a Funded risk sharing loan instrument, the EAFRD is not directly used to provide finance to final recipients, but the EAFRD is set aside in order to cover losses in case of default of a guaranteed loan.

At the individual loan level, guarantees are provided on a pari passu basis: the guarantor covers a fixed share of the loss on a single loan (e.g. 80%). In case the guarantee is called and payed to the bank due to the borrower's default, potential subsequent debt recoveries are shared according to the agreed risk sharing ratio. The risk sharing ratio is important to adjust incentives to minimise moral hazard from the lenders' side; it can be agreed at the level of the individual loan, or alternatively, at the level of the portfolio.

Losses on individual loans can be limited (capped) at portfolio level (Capped portfolio guarantee instrument). In this case (figure below), losses incurred on individual loans will be paid to the financial intermediary according to the agreed risk sharing ratio, but within a ceiling - the 'guarantee' cap - (corresponding to a given percentage of the total portfolio volume).

Figure 2: Risk Sharing at portfolio level



In an uncapped portfolio guarantee (figure above), losses incurred on individual loans are paid according to the agreed loss share with no limits at portfolio level.

In these types of instruments, in order to obtain a more efficient management of the risk at portfolio level, the guaranteed part of the portfolio is divided into tranches with different risks and different levels of seniority. The risk of the different tranches is normally born by different investors (e.g. the first losses due to the first defaulted loans will be covered using the first loss tranche, once the amount correspondent to this tranche is completely exhausted, possible additional losses will be covered using the second loss tranche, etc.).

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