Leveraging public resources through financial instruments to boost agri-competitiveness

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Agriculture is one of the only few fully integrated EU policies, with one of the largest share of the EU budget, as well as a key strategic priority for EU Member States. In order to ease the agri-financing gap and correct market failures, the European Investment Fund (EIF) has pioneered the deployment of agri-focused financial instruments. Mitigating financial risks and substantially improving credit conditions for farmers and agri-SMEs, these instruments have proven instrumental in promoting competitiveness, growth, and job creation throughout the EU agri-value chain. Moving forward, such approaches ought to be bolstered to tackle current EU agri-competitiveness challenges and build the food systems of tomorrow.

I. EU agri-competitiveness challenges and financing gap

EU agriculture is made up of over 10 million agricultural holdings and accounts for EUR 172bn of Gross Added Value, contributing slightly above 1% to the EU's GDP[1]. It is one of the key policy priority of the EU which has been fully integrated since 1962 and has consistently constituted one of the largest shares of the EU budget. However, in light of emerging threats, financial resources are not sufficient to fund the much-needed productive investments.

In order to achieve long-term economic growth, development measures promoting competitiveness are essential. In this respect, the agricultural sector is instrumental. Even though the GDP share of primary agri-production is rather modest, its economic contribution spreads throughout the value chain and has significant rippling effects on the manufacturing and services sectors. Specifically, the agricultural sector is heavily subsidised, although mainly via normative payments providing direct income support to the farmers. While these subsidies are important measures compensating farmers for their environmental services (maintaining the landscapes, preserving biodiversity, etc.) as well as for the social good in keeping rural areas alive, they contribute only partially to investments aiming at enhanced productivity, while a significant portion is absorbed in increased production and household consumption. It is therefore critical to boost productive investments with the required technological improvements that are necessary to accommodate the demand of both domestic and external markets.

The number of agricultural holdings has been in steep decline. Over 4 million farms ceased to exist in the past decade, which represents an alarming 25% decrease in the overall figure across the EU.[2] The underlining causes of such decline is manifold, stemming from income volatility and market uncertainty, the general ageing of the farming population or the difficulties in providing the means (i.e. input, technology, land, etc.) necessary for staying competitive in the business. Furthermore, the current level of investments is not sufficient to meet the market demand in the sector moving forward.

The ageing of the farming population is a threatening demographic issue that calls for solutions providing incentives for the succession of farming by the younger generation. Farmers, especially

[1] Eurostat (2019): "Agriculture, forestry and fishery statistics"
[2] Eurostat (2019): "Agriculture, forestry and fishery statistics"

family farmers are the backbone of rural areas. They keep the countryside alive and maintain the rural way of life.[3] However, the entry into agriculture, due to constraint access to farming resources, is difficult. The capital input required for many new entrants to the agricultural business is very high and potentially too risky, especially taking into account the low level of income that can potentially be achieved by farming during the first years. On top of that, for young farmers, the acquisition of sizeable land is often the only solution to start-up businesses or to expand them to a sufficient level in order to create viable activities.

According to FAO data, price volatility has been on the increase since 2007 and related market uncertainties are likely to remain a major concern for farmers in the coming decades.[4] Farmers typically have a high fixed cost base and this high dependency on volatile input costs (e.g. animal feed, fuel, seeds, fertilisers, etc.) leaves farmers particularly exposed to unexpected drops in cash flow. Income volatility is also affected not only by the natural seasonality of production but also by variance in yield due to external forces outside farmers' control, such as weather and animal diseases. The adverse consequences of such external factors will further increase on the back of climate-related challenges. All these factors can impact on a farmer's investment decision making process, encouraging pro-cyclical strategies, which often lead to market failures and sub-optimal investment situations, e.g. a farmer may invest when commodity prices are high rather when the investment is actually needed.

In order to remain competitive in the (world) market, EU agriculture requires modernisation of the holding, often with expensive investments on irrigation, technology, etc., where a positive rate of return is only realised on a longer run. Investments are also sought in order to expand production capacity, to diversify activities or to create the technological conditions of developing higher value-added products. Unfavourable terms and conditions of bank financing and market uncertainties often refrain farmers from such investments.

The European Green Deal paves the way towards transforming the EU's economy for a sustainable future, protecting the natural capital and biodiversity and tackling environmental challenges with the aim to become climate neutral by 2050. It involves cutting the use of chemical pesticides and fertilisers and promoting sustainable farming practices (e.g. organic farming, short food supply chains…), enhancing the use of renewable energy and developing a healthy and environmentally friendly food system alongside improved agricultural practices for water management and soil preservation. Technological investments reducing the use of natural resources, or reducing polluting emission as well as investments into more efficient equipment are areas, where the agricultural sector can contribute to achieve such strategic goals and where the financing sector would require a boost with external support.

The financial sector typically considers the agricultural sector as too risky and often involving high transaction costs. This implies that the interest rates charged for agricultural loans tend to be higher and/or collateral requirements more elevated than for other sectors. This has significant impact on the number of loans rejected, the number of agri businesses discouraged from applying for a loan, as well as insufficient loan amounts and tenors for the ones being financed.

The total financial gap in the agricultural sector is estimated to be between EUR 7.06 billion and EUR 18.60 billion, representing between 4% and 11% of GDP provided by the agricultural sector or between 13% and 33% of agricultural investment. From this financing gap between EUR 5.50 billion and EUR

[3] European Commission (2017): "A partnership between Europe and farmers"

[4] FAO (2016): "Concept note on the ministerial meeting on long-term commodity price trends and sustainable agricultural development"

14.48 billion account for medium and long term loans, while the rest covers short-term loans.[5] Among the overall target group, the financing gap is assumed to be higher for young farmers and small farms, that require specific attention of the stakeholders.

II. EIF experience in pioneering financial instruments for agriculture

To help bridge this agri-finance gap while contributing to promote job creation, rural development, sustainable agro-ecological transition, and climate co-benefits, the European Investment Fund (EIF) has been significantly scaling up its footprint in the agricultural sector since 2015.

EU Institution and member of the European Investment Bank (EIB) Group, the EIF manages resources on behalf of the EIB, the European Commission, national and regional authorities as well as other third parties in order to improve access to finance for SME across the European Union and Partner Countries. It does so by designing Financial Instruments aimed at mitigating some of the financial risk borne by Financial Intermediaries that are lending to or investing in SMEs. To this end, the EIF designs, promote and implement equity and debt Financial Instruments that specifically target SMEs. In this role, EIF fosters key EU policy objectives such as entrepreneurship, growth, innovation, research and development, employment, and – more recently – agricultural and rural development[6].

Capitalizing on over two decades of experience in structuring, originating, and managing such Financial Instruments, the EIF has been progressively building-up its know-how and expertise in agri-finance with a view of propping up this strategic sector by boosting investment, creating jobs, fostering agro-ecological transitions, and improving climate co-benefits.

Initially through "centralized programs", managed on behalf of the European Commission throughout the EU, the EIF has been working with partner Financial Intermediaries on selected agri-focused transactions. This helped build expertise and constituted a platform to develop tailor-made, "decentralized" approaches in partnership with national and regional authorities. Starting in 2015 with the French Region of Occitanie (within the flagship FOSTER Agri-TPE-PME umbrella program[7]), the EIF has been partnering with regional and national authorities to develop Financial Instruments exclusively focused on the agricultural sector[8] with dedicated investment strategies. In line with the policy priorities of the partner jurisdictions, these tailored national/regional programs leverage public contributions - originating from National/Regional Resources and, depending on the programs, European Structural and Investment Funds (ESIF) from the European Agricultural Fund for Rural Development (EAFRD) – to crowd in private financing and therefore catalyse investment. In line with a broad range of EU, national, and regional policy objectives, such approaches aim to promote productive investments undertaken by farmers and agri-SMEs in the development, processing, and marketing of agricultural products through an efficient, catalytic, sustainable, and revolving use of public funds.

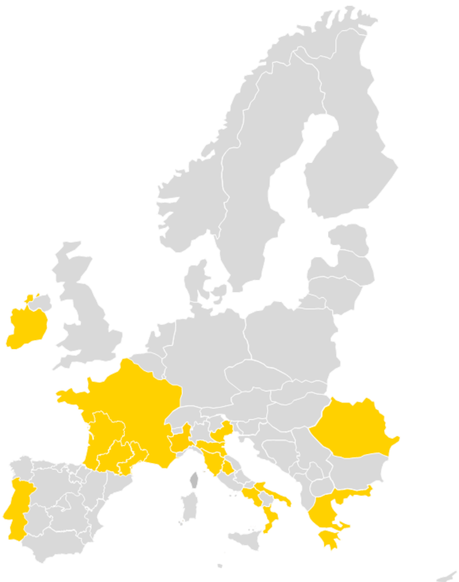
As a Financial Instrument advisor and manager, the EIF provides fully-fledged and well-tested solutions to Managing Authorities, including market-testing, selection of partner Financial Intermediaries - through an open transparent and non-discriminatory process -, negotiations and contractualization of the operational agreements, as well as transaction monitoring and termination. To further deepen

[5] Fi-compass (2018): "Financial gap in the EU agricultural sector"
[6] More information on the EIF website: https://www.eif.org/
[7] https://www.eif.org/what_we_do/resources/foster/index.htm
[8] Encompassing: (i) Agriculture, forestry and fishing and/or (ii) agri-food-forest and bio-based industries and/or (iii) relevant retail and wholesale and other services, depending on the programs

this strategic focus, the EIB Group together with the Directorate-General for Agriculture and Rural Development of the European Commission launched in 2016 the "EAFRD-EFSI[9] Initiative" to stimulate greater allocations of EAFRD resources to financial instruments. This initiative offers a comprehensive package for Managing Authorities, including a free of charge feasibility study prepared by EIB, a potential to mobilise EFSI resources, and EIF expertise in product deployment.

Across EU Member States, EIF experience proves that the need for agri-focused financial instruments is fully warranted to address market failures and policy objectives at the same time. Thus, as of March 2020, five EU Member States (France, Greece, Ireland, Portugal, and Romania), two French Regions (Nouvelle Aquitaine and Occitanie), and eight Italian Regions (Calabria, Campania, Emilia-Romagna, Piemonte, Toscana, Puglia, Umbria, and Veneto) are partnering with EIF on decentralized agri programs. Most of them are using EAFRD resources with the exception of France and Ireland that are only using national public resources. In the case of France, Greece, Portugal and the French Region Nouvelle Aquitaine, EFSI resources are also mobilized, as senior risk-taker to the EAFRD/national resources.

Figure 1 – Decentralized Agri Initiatives currently managed by the EIF on behalf of EU Member States and Regions



Source: EIF

Overall, this strategic focus has positioned EIF as the reference institution for financial instruments dedicated to agriculture and agribusiness. Specifically, EIF's manages financial instruments providing risk-coverage in support of the agricultural sector in the form of: (i) capped portfolio guarantees[10], uncapped portfolio guarantees[11], and portfolio risk-sharing loans[12].

[9] European Fund for Strategic Investments (or Juncker Plan)

[10] A Capped Portfolio Guarantee provides credit risk coverage to a Financial Intermediary on a loan-by-loan basis, up to a Guarantee Rate, for the creation of a portfolio of new loans to SMEs up to a Guarantee Cap Rate.

[11] An Uncapped Portfolio Guarantee provides credit risk coverage to a Financial Intermediary on a loan-by-loan basis, up to a Guarantee Rate and envisages partial capital relief to build-up an uncapped portfolio of new loans.

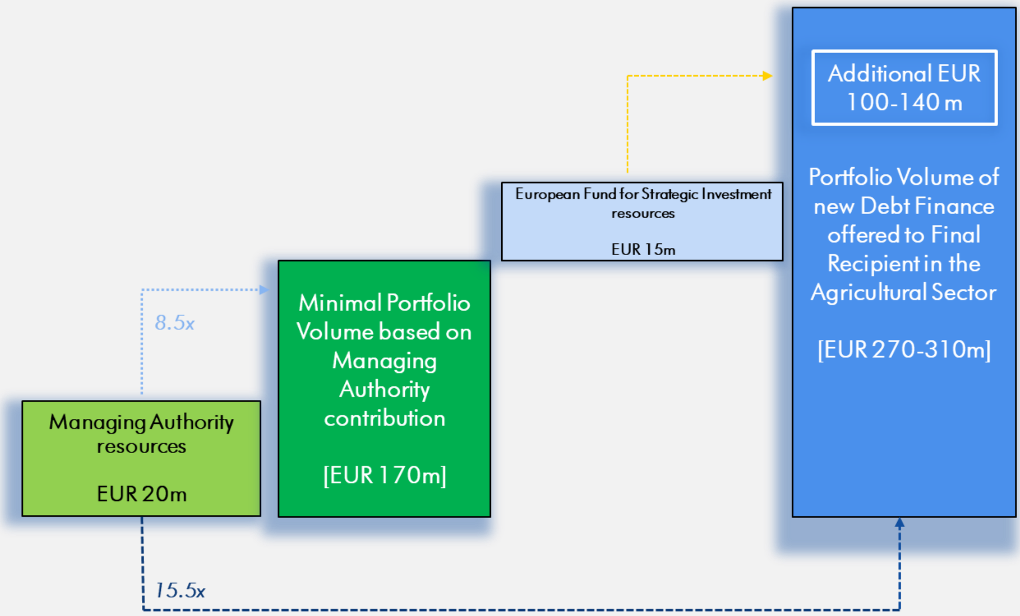
[12] A Portfolio Risk Sharing Loan provides liquidity to a Financial Intermediary for the development of a portfolio of new loans (portfolio to be co-financed by the Financial Intermediary) and receives coverage for part of the risk relating to such portfolio.

Box: EIF Decentralized Agri-program in Portugal

In Portugal, the Managing Authority decided to partner with the EIF to implement a capped portfolio guarantee instrument, with an EFSI contribution as senior risk-taker. With an EAFRD contribution of EUR 20m, the Member State contribution would leverage ca. EUR 170m of new finance, topped up with additional EUR 100-140m through EFSI, for a total of EUR 270-310m.

Four partner Financial Intermediaries have been selected (Caixa Geral de Depositos, Caixa Central de Credito Agricola Mutuo, Banco BPI, Santander) by the EIF. The program was formally launched on 10 March 2020 with the official signature of the guarantee agreements in Lisbon.

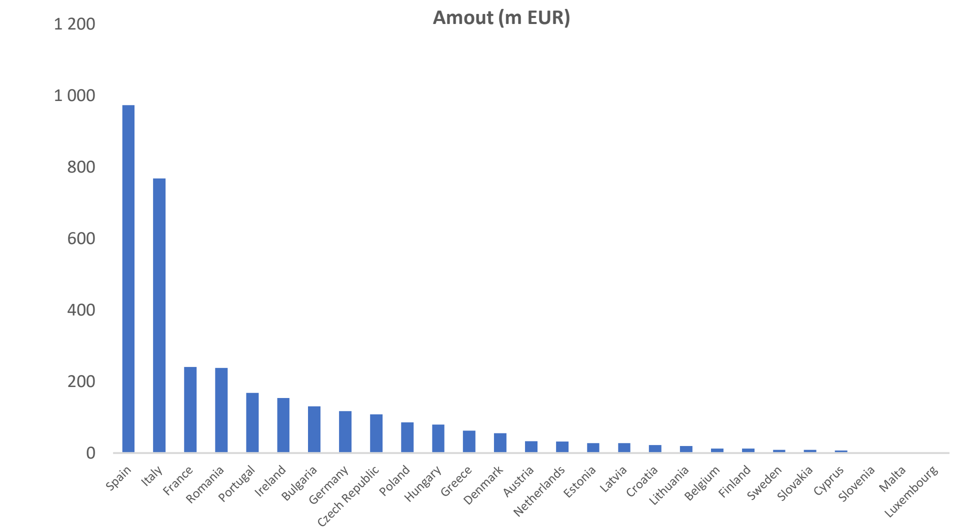
Leverage effect of the allocated resources

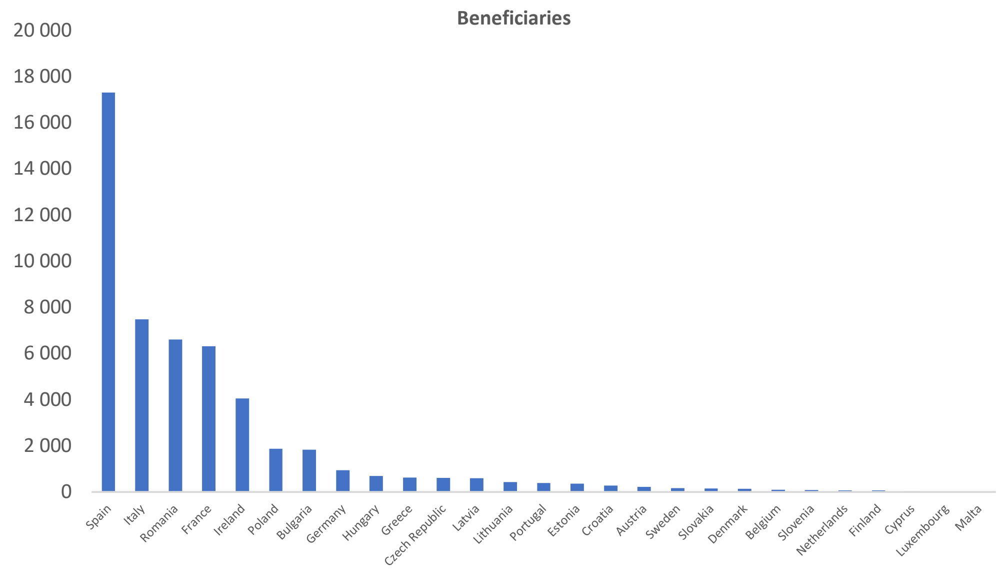


EIF's involvement in agriculture helps provide better access to finance for farmers, agricultural holdings, and entrepreneurs active in the rural economy. This is proving instrumental to facilitate access to finance for farmers and agri-SME, particularly for riskier projects and for final recipients lacking sufficient collateral. The partial credit guarantee provided makes possible higher volume of financing with longer tenors. More importantly, the transfer of benefit the partner Financial Intermediaries are compelled to pass on to the farmers and agri-SME, as per the operational agreements, entail significantly reduced interest rates and/or collateral requirements.

Through financial instrument implementation, EIF has therefore built a significant footprint in the financing ecosystem of the EU agricultural value chains. As of March 2020, EIF has catalysed over EUR 3 billion of financing approximately 50.000 farmers and enterprises active in the agriculture, forestry and fishery sectors.

Figure 2 – Financing through the initiatives in the agricultural sector currently managed by the EIF[13]





Source: EIF

III. Way forward for agri-focused Financial Instruments

With an investment gap in the range of 13-33% of current investment, alongside acute competitiveness challenges spamming unfavourable demographic trends, price volatility and climate-related threats, the EU agriculture is currently at crossroads. Meeting these challenges require ambitious investments to improve competitiveness, increase added-value, adapt to climate-related threats, and ensure the necessary renewal of generations. In this respect, investment support for the acquisition of machinery and equipment, the uptake of agri-technology, the purchase of land, and enhanced soil and water management systems are particularly warranted, especially for young farmers.

[13] Data on all EIF activity since 1999 falling under: Agriculture, forestry and fishing

EIF's pioneer experience in developing and managing agri-focused Financial Instruments offers an answer. The fully-fledged package made available to EU member states and regions provides tailor-made solutions to catalyse productive investments in agriculture, in line with the policy objectives and rural development needs of the jurisdiction. By mitigating the risk of financial intermediaries and significantly improving farmers and agri-SMEs' credit conditions, such approach is proving instrumental to mobilize sufficient financial resources. Moving forward, to further deepen this contribution, especially in light of competitiveness and sustainability challenges, the scope of the second generation of agri-focused financial instruments could be further broadened.

Due to increased pressure from the globalised market, the agricultural sector should focus more and more on the production of processed, high value-added products. That requires expensive investments, or causes temporary income gap associated with the change in production subsectors (e.g. from beef to dairy, non-organic to organic, etc.). Financial instruments can indeed give a hand to tackle such shortage of capital and liquidity.

Refundable and non-refundable forms of instruments should not operate in silos, but should form part of an integrated strategy. Indeed, high value instruments can be created that bring together grants, financial instrument and potentially technical assistance as well. Blending of various forms of support and resources create an added value to support the implementation of viable investments by agricultural businesses and to achieve certain policy goals and create greater impact in the economy overall. Upcoming EU regulation should enable such combination.

Generational renewal in agriculture are fundamental for the sustainability and long term competitiveness of agriculture in the EU. Starting an agricultural business usually requires a substantial investment. At the same time young farmers typically lack collateral and track record to convince banks to finance them and their new farming businesses in standard terms. Financial instruments can play an important role in combination with grants to support young farmers in carrying out investments to start their businesses. In order to mitigate the constrained access to land, it is foreseen that in the next programming period land purchase would be allowed for young farmers without the current 10% threshold of the investment.

The challenges stemming from price and income volatility call for an integrated and coherent approach for risk management, where financial instruments could take a pivotal role with the aim of moving away from a pure subsidy approach tackling agricultural disasters towards a more sustainable model combining subsidies with financial instruments.

Agriculture is the most important contributor to achieving environmental sustainability goals and will have an important role in meeting climate action targets in the future. Therefore, in line with the "aquis" of the new Green Deal, support to investments that promote climate resilience and climate mitigation will be of paramount importance.

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