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Bank Lending To Small and Medium Sized Enterprises in Rural Areas; an Analysis of Supply and Demand

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for Reconstruction and Development

ROMANIA

BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND

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Currency Equivalents
(2005)

1 Euro = 40,125.5 Romanian Lei (ROL)

1 US Dollar = 30,731.0 Romanian Lei (ROL)

Abbreviations

CDE	Centre for Economic Development
EUR	Euro
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
IFI	International Financial Institution
MAFF	Ministry of Agriculture, Forestry, and Fishery
MFI	Micro Finance Institution
NBR	National Bank of Romania
NGO	Non-Governmental Organisations
PPS	Purchasing Power Standard
ROL	Romanian Lei
RCGF	Rural Credit Guarantee Fund
RDA	Rural Development Associations
SAPARD	Special Accession Programme for Agriculture and Development
SME	Small and Medium Enterprises
UNDP	United Nations Development Programme
US$	United States Dollar

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EXECUTIVE SUMMARY

Overall Economy and Rural Business Environment

i The economic situation in Romania has improved over the last years and starting in 2001 the growth rate averaged some 5 percent per year. Also the development of the financial sector has gathered pace and domestic and foreign direct investments, in view of the country's accession to the EU in 2007, are rapidly picking up. These favourable trends, however, are far from being evenly distributed over the territory: Bucharest and a few other big towns in more favourable regions account for the bulk of the growth, while a large part of the country's economic potential, representing small cities and rural communities, is not fully utilized. One of the reasons that financial resources allocated to rural areas remain under-utilized is the inadequacy of financial services to match the needs of local business, notwithstanding the number of specially designed financing programs in this respect

Small Enterprise Finance

ii The main source of finance for starting a small business are own funds from savings or remittances. However, reliance on limited own financial resources and lack of access to external funds have condemned many SMEs to low operational efficiency and a limited scale of operations, thus affecting their further development. Moreover, existing small and medium-sized enterprises (SMEs) in Romania, in order to comply with the new EU norms and standards and to expand and to diversify their activities, normally are not able to accumulate enough internal resources from retained profits to make major investments in the required restructuring of their facilities and to obtain new equipment. These enterprises require for this purpose access to outside funds in order to pursue their development. External funds may come from various sources such as commercial business suppliers, banks and leasing companies, equity investors and capital markets (although normally not accessible for SMEs) and others like government, international financial institutions and non-governmental organizations. Bank loans, a potential important business financing source, still covers only a small percentage of the financing needs of SMEs in Romania (some 10% in 2002)

Bank Lending

iii Commercial banks are by far the strongest players in the Romanian financial system: 30 banks and eight branches of foreign banks operate in Romania and majority foreign-owned banks account for almost two thirds of the total bank assets. Bank credit to non-government in real terms grew by 50% in 2003 and, in particular, consumer lending but also leasing finance and, more recently, mortgage lending are expanding rapidly. Still, the money supply and non-government credit in Romania as percentage of the GDP are lower than in any other accession country and it is often argued that the supply of bank loans to SMEs is weaker than the potential demand for such services. In this study no attempt has been made to quantify the unmet demand for credit by SMEs in rural areas, since the effective demand typically depends on the price and other terms at which bank loans can be supplied in a sustainable way. Instead, emphasis has been given to an assessment of the determinants of the demand as well as to the factors which constrain the supply of bank loans to rural SMEs.

iv Banks are selective in choosing their clientele and potential borrowers see bank lending terms as unfavorable. Average lending rates exceed 26% p.a. for domestic currency loans, although the inflation rate is expected to move to a single-digit figure by the end of 2004; conventional loan collateral, normally mortgage, is required at a value that may be 250% of the loan value; and short-term loans (up to 12 months) predominate. Differences exist, however, between larger and smaller more aggressive banks: the first ones may offer better lending rates and have a wider choice of loan products, including with longer maturities, but small clients complain that large banks are not acting like business partners; small banks, on the other hand, normally charge higher lending rates and do not offer term loans for investments, but they tend to treat their small clients better.

v Lending terms are even more unfavorable for SMEs in rural areas, in particular, in those smaller communities where banks do not have branches or agencies. Few rural SMEs apply for bank loans and even less of them are successful in receiving loans. In July 2004, credit to agriculture, forestry and fishery (Taken as a proxy for rural credit, although admittedly it does not include credit for farm-related and non-farm rural economic activities) represented a mere 2.6% of the total bank loans above EUR 5,000 that were extended. The major reasons quoted for the under-representation of rural credit in the overall loan portfolio of banks are:

- absence of bank branches in smaller rural communities due to the high transaction costs and non-profitability of rural lending;
- bankers' perception of rural clients as being risky due to their low repayment capacity and credit discipline;
- a lack of trust that rural people have in banks and bank services;
- lending terms of banks which do not correspond with the specific features of rural clients and types of investments in rural areas; and
- non-compliance of potential rural borrowers with the loan application requirements of banks, including their lack of capability to prepare adequate business investment plans.

Rural Credit Supply Constraints

vi High transaction costs and risks are the main factors which affect the supply of bank credit in rural areas.

Bank Transaction costs

vii The presence of banks in smaller rural communities is weak and they are reluctant to open new bank branches or agencies in rural areas, because large cities offer plenty of profitable business opportunities and room for expansion. In fact, transaction costs of banks in rural areas are high without being compensated by corresponding high revenue levels and the bottom line is reached when the total costs of operating a small retail bank outlet with a low volume of transactions are not compensated by earned income. Banks which inherited a large branch network (the case of the Raiffeisen Bank, but also Banca Comerciala Romana and BRD-Groupe

Société Générale) keep shrinking their presence in small communities. The World Bank Rural Finance Project which was launched in 2001 has been also until now not successful in its attempts to enlarge the network of retail bank units in rural localities by offering to finance the incremental expenditures incurred and to provide related staff training and technical assistance.

Bank Credit Risks

viii In particular, agricultural production loans are subject to both high physical risks (unfavorable weather and large outbreaks of crop pests and animal diseases) and economic risks (depressed markets and prices), which affect the profitability and repayment capacity of farmer borrowers. These loans, and even more so investment loans which are characterized by increased uncertainty due to longer time horizons, require specific risk management mechanisms at farm level such as the availability of irrigation facilities, good farm and business management practices, farm enterprise diversification and insurance coverage. A distinction should be made between:

- individual borrower risk (problem of asymmetric information between lender and borrower); and

- general or systemic risks related with lending to a new type of clientele such as rural SMEs (overall lack of information, ineffective loan supervision, and collateral problems); risks that affect a whole region (physical risks in agriculture) or are related with a specific economic activity or sector (for instance, the competition threat of Asian countries, in particular China, in the textile industry); and risks of a policy or political nature such as the new norms and standards that are required for Romania's accession to the EU or the use of non-transparent national subsidy programs.

ix Systemic risks, which are largely beyond the control of financial institutions, will have, in particular, a severe effect on those institutions that have an undue concentration of their loan portfolio on a specific clientele, geographic region or economic sector. This explains the normal prudential character of banks in selecting their clientele, matching the maturity of their assets and liabilities, and diversification of their loan portfolio.

Loan Collateral

x Collateral refers to the assets that are pledged by the borrower to the lender until the loan is fully repaid. Banks can reduce to a certain extent their information-related problems and credit risks by the use of collateral which has two main functions. First, it serves as a screening device of potential borrowers who intend to make good faith efforts to fulfill their loan repayment obligations and thus makes willful loan default less probable. Second, it reduces credit risks by providing the lender with an additional source for loan repayment by liquidation of the collateral asset in case of actual loan default. SMEs In Romania perceive the excessive reliance on conventional collateral (normally, mortgage is required) and a high collateral value (250% or higher than the loan value) as the main constraints to bank loans for investments. In fact, the determining factor for rural SMEs in selecting the source of loan finance that they need is the lower collateral requirement.

xi The usefulness of rural collateral to lenders, however, is negatively influenced by uncertain legal procedures related with foreclosure in case of loan default and the difficulty to sell seized rural assets such as farm land, houses and machinery. As a result, rural fixed assets are evaluated very conservatively by banks, while they often insist on mortgage of urban real property. On the other hand, micro finance institutions in Romania such CHF International and also the Miro Bank, adopt in their rural lending a much more flexible approach, while they use also a combination of different collateral types such as mortgage (above a certain loan value and for investment loans), movable assets, and personal guarantors. For instance, for CHF the combined collateral value for both standard business loans (up to USD 20,000 and 2-year duration) and short-term business loans (up to USD 5,000 and 3 months maturity) equals to 120% of the loan value plus interest. In the case of the Miro Bank, for rural business loans (up to EUR 50,000 and 5-year duration) the total collateral value is 110% of the loan value of which 70% should be mortgage (for loans above EUR 25,000), while for farmer loans (up to EUR 10,000 and 2-year duration) there is no need for mortgage.

xii Some priority actions for Government authorities and banks in the field of loan collateral would be:

- To complete the issuance of ownership titles for farm land and to develop an active land market by establishing a countrywide land registration system; in this context consideration may be given to subsidize for small farmers the excessive high land registration fees as well as the required notary fees for mortgaging and land ownership transfer.

- To support a wider adoption by banks of rural movable assets as collateral by complementing the utilization of an already existing electronic database of movable guarantees with improvements in the corresponding legislation and better law enforcement mechanisms of contracts.

- To facilitate in the context of the already developed warehouse legislation system the use of negotiable warehouse receipts of crop inventories as loan collateral by establishing a special Indemnity Fund and by widening the number of participating qualified warehouses. This will contribute to the development of both agricultural lending and agricultural commodity exchange markets for grains and other products.

- To increase the capital base of the Rural Credit Guarantee Fund and to widen the current scope of guarantees to all viable rural economic activities.

- To support banks with technical assistance and staff training to improve their current evaluation methods of rural collateral assets and to facilitate the combined use of different types of collateral in rural lending.

Leasing Finance

xiii Leasing operations represent a fast growing market in Romania with an expected turnover in 2004 of EUR 1.8 billion. Car business still represents more than 90% of the local leasing transactions and equipment imports used to be financed through offshore leasing companies. However, in the last two years a small but increasing share of the domestic leasing market has been directed to equipment. Potential SME clients in rural areas look at leasing finance of required machinery and equipment as an attractive alternative to bank lending due to the serious constraints that they encounter in complying with bank loan collateral requirements.

Credit Guarantee Funds

xiv Credit guarantee funds have been established to facilitate the difficult access of small clients to bank loans by sharing the loan default risk between the borrower, the lending bank and the guarantee fund. The Rural Credit Guarantee Fund (RCGF), one of the three existing guarantee funds in Romania which have been set up with international assistance, is the most relevant one for SMEs in rural areas. It guarantees investment loans up to 70% of the loan value for which a commission fee is charged to the bank. Normally this fee is passed on to the borrower with the exception of individual farmers and farmer associations for whom the commission fee is borne by the Fund. Since mid-2002, improvements in the guarantee conditions have made the RCGF more attractive to banks and the guarantees have increased by almost six times between 2002 and 2003, exceeding EUR 44 million. However, two problems for which concerted action between the Government/donors and banks are required, remain to be resolved:

- Increase of the existing capital basis of the Fund (currently some EUR 12 million, mainly provided by the EU), in order to be able to expand the guarantee operations in accordance with financial prudential norms;

- Widening of the scope of the RCGF to include all types of viable rural economic activities, since the Fund currently does not extend guarantees for rural industries or services other than farming and agro-processing.

Rural Finance

xv Lessons from the World Bank Rural Finance Project and other lending activities of banks in rural areas (The IFAD Apuseni Mountain Project, the German – Romanian Fund, and the Miro Bank) show that embodied restrictions regarding the target clientele (insisting, for instance, that only small rural communities and new bank clients should be included), the scope of the credit (e.g. excluding the financing of the purchase of land or buildings), and on lending through a large public bank instead of using NGO-based micro finance institutions or small banks in order to lend to small farmers and rural business, should be avoided as much as possible.

xvi SAPARD grant funding in Romania is based on an annual EU/Government allotment of EUR 204 million over the period 2000-2006 and it constitutes the major source of finance for investments in rural areas. The various types of eligible public and private investments (so-called "Measures") reflect the priorities of the national agricultural and rural development program of the Government. SAPARD finances half of the total costs of private investment projects (100% for public investments like rural infrastructural works), with the remaining 50% coming from the investors' own money and bank loans. Investments may include development of specific farm enterprises, sustainable environmental agricultural production activities (like organic farming), diversification of rural economic activities, agro-processing and marketing, forestry development and rural tourism. The absorption capacity of the SAPARD funds has been slow with the exception of the financing of rural infrastructural investments. SMEs in rural areas complain that SAPARD is political and bureaucratic, painfully slow and costly (timely business investment opportunities are missed) and mainly meant for larger investment projects: e.g. agro-processing investments require a minimum SAPARD financing amount of EUR 30,000 but have a ceiling of up to EUR 2 million. Moreover, the benefit of co-financing a SAPARD project with a bank loans is not obvious due to the risk that a bank incurs when, after having pre-financed first the SAPARD funds, at the end the investment eventually results not to be approved.

Small and Medium-sized Enterprises (SMEs)

xvii SME statistics in Romania are not up-to-date: the most recent figures refer to 2002, while the data for 2003 will not be available before the end of 2004. No separate statistics exist for SMEs in rural areas and the information used in this report comes from the estimations of few studies that have been carried out on this subject. Official figures on registered SMEs include, apart from small and medium-sized enterprises, also micro-enterprises, since the distinction by enterprise size is made only on the basis of the number of (permanent) workers. In fact, there are no marked structural differences between micro- enterprises (less than 10 permanent workers) and small enterprises (between 10 and 50 workers). In 2002 there were in total 341,168 privately owned registered SMEs (with between 0-250 workers) and, out of these, micro-enterprises dominated the market (89%) against 9% small and 2% medium-sized enterprises. As could be expected, the largest numbers of micro-enterprises are found in the services sector, in particular, in small trading activities. Small enterprises operate also mainly in services followed by manufacturing activities, while medium-sized enterprises predominate in the various industrial activities. SMEs are responsible for a significant share of the total private enterprise activities as is evidenced by the economic indicators on their turnover, gross value added, gross profits, and gross investments, which account for at least some 60% of the total results of all private enterprises. An exception are the exports of SMEs, which represent only 15% of the total private enterprise exports. This indicates that SMEs predominantly work for the domestic market, although the export share of SMEs in some more export oriented sub-sectors, such as in wood and furniture, textiles and garments, and glass and ceramics, can be substantially higher.

Demand for Finance by Types of Rural Investments

xviii According to estimations of a World Bank study dated January, 2001 which uses data from 1998, there were some 80,000 registered rural SMEs. In small rural communities with up to 50,000 inhabitants, normally the main economic activities that are carried out include farming and services activities such as small trade, workshops and handicrafts. However, rural business includes also agriculture-related processing activities (agro-processing) which is often concentrated in larger communities in or close to higher potential agricultural production areas, and location-specific, non-farm rural economic activities. In order to assess the different investment requirements and to examine the potential loan demand features of SMEs in rural areas, a comparative analysis has been made of those economic activities in rural areas which are considered to present comparative benefits and are favored by specific policy measures and financial support schemes. An initial focus of bank lending on these rural economic (sub) sectors may result to be most profitable.

Rural economic sectors and sub-sectors – Potential bank loan demand by SMEs

SUBSECTOR	*POTENTIAL*	*CONSTRAINTS/RISKS*	*INVESTMENTS / BANK LOANS*
		AGRICULTURE	
Agricultural production	*High but under-utilized potential (land and labor) for grains, oil crops, fruit & vegetables, wine, forestry. Fast expansion of organic farming.*	*Excessive land fragmentation and subsistence farming Low capital use, technology level and produce quality Low added value of agricultural exports. Land mortgage collateral problem. Lack of agricultural insurance tradition.*	*Integration of farming in food chains needed. Investments: inputs, crop varieties/ animal breeds, buildings, equipment, irrigation. Profitable activities: grains, soybean, fruits, wine, organic/niche products, local pig production (sausages)*
Milling & Baking	*Grain products are a main part of the food basket. Over 4,900 SMEs and ongoing enterprise consolidation.*	*Local production of grains does not meet demand of processors. Lack of storage. High competition.*	*Linkages needed with local grain producers. Investments in storage, restructuring of plant facilities, equipment, and quality control.*
Fruit & Vegetables	*Local consumption/ export tradition and competitiveness (low labor costs). SAPARD finances new greenhouses.*	*Farm fragmentation and subsistence production. Lack of regional wholesale markets of fresh products for processing. Long gestation period of new orchards and seasonal cash flow.*	*Investments needed in long-term land use, orchard renewal, specialization of processing, new equipment, quality standards for exports, better packaging.*
Vineyards & Wine	*Good production and export potential in terms of price/ quality relation of various wine types.*	*Weaknesses along whole chain of vineyards, wineries and domestic & export marketing. Long gestation of new vineyards*	*Investments in long-term land use, vineyard renovation, wine processing and promotion/marketing.*

SUBSECTOR	*POTENTIAL*	*CONSTRAINTS/RISKS*	*REPAYMENT CAPACITY*
		DAIRY	
Milk & Dairy Products	*Regular income for small farmers from direct market sales. Large FDI in dairy industry: growth of local demand for processed products.*	*Self consumption and low milk supplies to plants. Fresh milk quality does not comply with EU norms.*	*Strong integration needed between milk farms & dairy plants. Investments in milking equipment, cold storage & milk collection system.*
		MEAT PROCESSING	
Meat Processing	*Low but growing local meat consumption, in particular of sausages and chicken.*	*Limited supply and quality of local raw meat for processing Hygiene & quality main EU issues: (threat of closing slaughterhouses)*	*Major investments for restructuring and new equipment in 2005/06 of slaughterhouses & processing plants as SAPARD priority.*
		TOURISM	
Rural Tourism	*Many micro- and small enterprises (bed & breakfast). Good value/cost ratio of rural, health and cultural tourism.*	*Lack of concerted efforts between private and public sectors (promotion, marketing, ITC, road infrastructure). Lack of collateral.*	*Finance needed for refurbishment of accommodations, internet facilities (online reservations) and better business support services.*
		TEXTILE AND OTHER	
Textile & Garments	*Fast growth of SME garment manufacturers contracted by West European stores. Competitive skilled workforce in design and manufacturing.*	*Threat of Chinese price competition after liberalization of textile market. Low profit margins Inadequate bank lending to adjust to fashion changes.*	*Priority to CAD and CAM equipment and internet facilities in bank lending to remain competitive/ to keep ahead of the demand changes in main international clothing markets.*
Wood & Furniture	*Competitiveness (large forest lands and cheap labor). Good tradition and growth potential for production/exports*	*Low capital use and lack of bank finance for SMEs in wood harvesting/cutting due to a lack of collateral assets.*	*Wood & furniture are Government priority. Investments for compliance with EU environment norms, restructuring & new equipment needs.*
Glass & Ceramics	*Competitiveness of tableware and decorative product exports (not for industrial glass).*	*Issues: high capital intensity, cost containment, cash flow, and foreign competition.*	*Investment needs for upgrading of kiln and furnace and new equipment exceed USD 100,000.*

Type of Rural SME Borrowers

xix A first observation to be made is that rural areas and the location of registration or operation of SMEs should not be defined too restrictive (i.e. limiting to only those SMEs whose core activity is carried out in communities up to 50,000 inhabitants), as this would mean that then mostly only farms and small-scale services activities such as trading and workshops would be covered. Many SMEs in food and agro-processing, but also some non-farm rural business activities like glass & ceramics and textiles & garments would be thus excluded. Agro-processing and farm activities are, however, closely linked and, in fact, the current ongoing process of forming farm/agribusiness groups and integrated food chains is of crucial importance for the necessary development and modernization of agricultural production in Romania as well as beneficial to producers, consumers and the economy as a whole. At the same time, in particular, food processing SMEs are faced with major investment needs in view of Romania's accession to the EU in 2007. In case they are not able to comply with the high EU hygienic norms and food quality standards in 2005/06, they will be forced to close down with the effect of substantial losses in added value and local employment. A second point is that, in view of the low profitability of a single activity and the seasonality of some business activities, rural SMEs often are engaged in more than one activity and have different income sources. This diversity is normally the cause of lower enterprise efficiency and profitability but also of lower risk, since the firm can use to varying degrees different income sources for loan repayment.

Priority Regions

xx One may expect that banks which decide to extend their business lending operations to rural areas will concentrate their operations initially in specific geographical regions where they have existing bank branches or agencies, or, where for various regions, they have already decided to open new bank retail units. In these regions they may decide to select individual rural SME borrowers on their own merit covering various types of potential economic activities, or they may focus on a limited number of clusters of more profitable rural economic (sub) sectors chosen among farm enterprises, agro-processing, and non-farm rural economic activities and gradually build up their knowledge of these sectors. In all pilot lending operations it makes much sense for a bank to start first in more favorable regions for rural business activities and to capitalize on the most economic use of a limited volume of loan resources. This approach has clearly the potential to reduce the bank risks and to increase the value added as compared to an alternative strategy geared to a more balanced territorial distribution of the bank loans.

Loan Repayment Capacity

xxi Before a bank decides to lend to SMEs in rural areas, it needs to be pretty sure about the probability of repayment of loans by potential borrowers and for that reason banks will closely examine:

- The financial performance of a SME/loan applicant: The rural business firm has to prove that it has registered a profit, at least for the last operational year, and that it has no outstanding debts to the state in the form of taxes and social security payments.

- The collateral offered by the enterprise should be able to secure loan repayment: for investment loans (but even for short-term loans) banks in Romania, normally, insist on mortgage of urban real property and an appropriate balance between mortgage and other solid securities which may include letters of guarantee.

- Investment profitability: The enterprise has to demonstrate, through financial documents prepared for the bank, that the investment is profitable i.e. projections of the expected business results should show a positive cash flow during the loan duration.

- Financing sources for loan repayment: The company has to prove that it has firm client orders and signed commercial contracts. In general, deposited export orders/contracts are considered a good guarantee for loan repayment.

xxii In interviews with rural entrepreneurs the FAO team was not presented with any financial statements, while, apart from the provision of some rough estimations of positive business results, no firm evidence was collected on the profitability of the visited SMEs. It was also observed that conventional loan collateral i.e. mortgage predominates in the loan decisions of Romanian banks and rural assets such as owned land, buildings and equipment are evaluated very conservatively; the required collateral value often represents up to 250% of the loan value. All SMEs which are engaged in rural business activities with a low capital intensity (the majority of the examined economic sub-sectors above with some exceptions for medium-sized commercial farmers, grain mills, dairy plants, meat processing factories, wineries/bottling plants, wooden furniture making, and glass & ceramic plants) will have problems in meeting the conventional collateral requirements of banks. A closer examination of rural SME in the Timis county (which firms received business loans of up to USD 20,000 and with a maximum duration of 2 years from CHF International, a micro finance institution) showed, however, positive cash flows and current ratios of (far) above 1.5, indicating that these enterprises have no trouble in paying back fully their business loans as well as short-term, commercial creditors.

Financial Products of banks

xxiii The results of the survey of SMEs in Romania published by the National Agency for SMEs and Cooperatives in October, 2004 show a traditional use of bank products: the large majority of SMEs had opened current bank accounts and about 20 percent (small enterprises) to 30 percent (medium-sized enterprises) had savings accounts; some 20% of medium-sized enterprises used credit cards. Short-term credit from commercial suppliers varied between 18 and 25 percent. The main source for investment finance remains own capital (88% in the case of larger investments and 77% for small investments) and only between 7 and 9 percent of the SMEs had received investment loans from banks, normally with a duration between one to two years. Of the agricultural production SMEs only 5.4% plan to use bank loans in addition to own funds and they expect to have access also to Government support programs. Only 11% of the SMEs said that they intend to apply for SAPARD finance. Determinant factors in selecting the source of finance for large investments are low interest rate (55%), simple and rapid procedures (52%) and low collateral requirements (32%). The maturity of bank loans is considered too short and grace periods are needed for loans which finance investments with a certain gestation period. Bank inflexibility was mentioned, meaning that a borrower can have only one loan at the same time, although there is a need for both investment and working capital loans. Bank procedures and bank products are as not adapted to the specific features and financing needs of rural SMEs. In general, banks are perceived as discriminating against small enterprises, conservative and not pro-active. This last point together with the finding of the FAO Survey of rural SMEs that a high proportion of the SMEs appear to be poorly informed about the bank requirements for loan applications and on loan appraisal and approval procedures would indicate that there is much need for active marketing programs of banks. The FAO survey found also that the range and quality of non-financial business advisory services that are currently available to rural SMEs is very limited and needs urgently to be further developed and to be made sustainable over time.

xxiv Sequencing of loan products and graduation of clients are practices which are normally used by micro finance institutions and banks which plan to extend their lending operations to SMEs in rural areas may want to use these experiences. In fact, to start with the provision of short-term production or working capital loans may be a good way to build up the credit history records of new borrowers as well as knowledge on loan repayment behavior, specific rural economic activities and local conditions. Moreover, new rural SME borrowers who have had already current bank accounts and, in particular, savings accounts for some time, may be granted more flexible overdraft facilities for their working capital needs of which the ceiling can be gradually expanded. In particular, in the case of more risky agricultural loans it may be recommendable for banks to extend short-term emergency loans or to reschedule existing loan repayments in order to respond to acute liquidity constraints on the part of the borrower. After a number of rounds of short-term working capital loans (which may increase in loan size over time) existing borrowers may eventually graduate to longer-term investment loans. These may be distinguished between medium-term loans (normally between 1-5 years) to be used for enterprise expansion and diversification and acquisition of machinery/equipment and long-term loans, for instance, for land purchase, construction of buildings and renovation or establishment of perennial cultures such as vineyards and orchards.

1. INTRODUCTION

1.1 The Romanian financial sector remains rather weak, albeit progress has gathered pace in the last few years. Rampant inflation, a poor regulatory framework for non-bank financial institutions, and several scandals involving banks and other financial institutions have all contributed to that situation.

1.2 In recent years, however, the overall economic situation and that of the financial sector have significantly improved. The country's economic growth rate averaged some 5 percent starting 2001, and will possibly exceed 7 percent in 2004; inflation is set to decline to a single-digit figure by end-2004; bank credit in real terms grew by 50 percent in 2003 and by 20 percent in 8 months this year, while other financial services such as consumer and mortgage lending and leasing finance are in full swing. The European Commission has reconfirmed the year 2007 as the target for Romania's accession to the EU, thus paving the way for growing foreign direct investments and stronger economic expansion – much needed for reducing the gap with the EU countries' average economic level.

1.3 Major international rating agencies have not yet upgraded Romania to investment grade as far as long-term debt is concerned, however, the markets' perception of Romania has markedly improved. Hence, Romanian sovereign bonds are traded on secondary market with spreads varying between 60 and 80 basic points and the demand for Romanian debt instruments is high.

1.4 Favourable tendencies, however, are far from being evenly distributed over the territory. Bucharest and the surrounding area, and a few other big cities account for the bulk of the growth, while small cities and rural communities are largely left aside. Thus, a significant part of the country's economic potential is under-utilised. While own capital is the main financing source for starting an enterprise, for existing SMEs in Romania, who need to invest, in particular, in restructuring, expansion or diversification of their activities, internal resources from retained profits will not be enough and they will need access to outside funds in order to pursue their development. External funds may come from various sources such as commercial suppliers, banks and leasing companies, equity investors and capital markets, and others like governments, international financial institutions (IFIs) and non-governmental organisations (NGOs). Bank loans, a potential important business financing source, still covers only a small percentage of the financing needs of SMEs in rural areas in Romania,, while the situation is a bit better for larger enterprises and in bigger towns.

1.5 IFIs and NGOs have launched special programmes dedicated to supporting disadvantaged rural communities, but much remains to be done before these areas will be fully integrated in the overall economy and their sustainable connection to the country's economic expansion is achieved. The new EU/EBRD SME Rural Credit Facility (henceforth the Facility), analysed in this report, is meant to be such a programme. The Facility is earmarked for small- and medium-sized enterprises (SMEs) located in rural communities. SMEs in Romania are defined as companies with between 10 and 250 permanent employees and an annual turnover of up to €8 million. The programme defines "rural" in Romania, in accordance with the EU, as communities of up to 50,000 inhabitants (NUTS 5 level).

1.6 The EBRD aims at extending lending resources through commercial banks and, possibly, eligible leasing companies. Moreover, the new Facility is intended for well-established businesses with an indicative loan size ranging from as low as €15,000 up to €250,000. Micro credit and credit to individuals are not included in the scope of the Facility. Such an approach seems appropriate, considering the limited size of the Facility and the commercial nature of the credit. However, in the event of future expansion of similar facilities for financing SMEs in rural areas, the scope could be widened, as far as both financial intermediaries and the size of the loans and enterprises are concerned. The Facility also incorporates a technical assistance (TA) grant, designed to develop this type of loan business.

1.7 The present report is structured as follows. After this introduction the second chapter assesses the supply of rural credit for the intended users of the Facility with an emphasis on banks. An overview of the macroeconomic conditions in the country sets the ground for recommendations regarding the Facility and the future strategy of the EBRD versus rural finance in Romania. The potential role of leasing companies and micro finance institutions (MFIs) in the Facility is also treated in the same section. Main programmes and mechanisms and experiences with agricultural and rural credit in Romania are presented.

1.8 The third chapter focuses on the potential demand for bank credit by SMEs in rural areas. While available information and statistics are rather unstructured and not up-to-date and, in general, do not perfectly match the target group of SMEs in rural areas, one may assume that the picture is sufficiently accurate and supportive of the proposals that are made. The main conclusion is that the demand for credit by rural SMEs is growing and the disbursement of the loan resources to be provided under the Facility may not be delayed too long. Flexible conditions, long loan maturity, the availability of TA, and the possibility to use the funds under the Facility as pre- and co-finance together with SAPARD investment projects will also speed up its disbursement.

1.9 The fourth chapter is devoted to the conclusions and recommendations regarding the design of the Facility as well as discussing relevant policy issues related to widening the scope of similar future facilities, assuming that the EBRD is interested in continuing its catalytic role of stimulating the growth of less favoured rural regions in emerging transitional economies.

1.10 The results of a FAO survey of SMEs in rural areas, interviews with banks and SMEs during the missions of the FAO team and assessments of relevant rural economic sub-sectors are illustrated in both the main report and more in detail in dedicated annexes. They are meant to broaden the picture and to provide additional information on the topic in discussion.

2. ASSESSMENT OF THE SUPPLY OF CREDIT TO RURAL SMALL AND MEDIUM-SIZED ENTERPRISES

2.1 Recent Macroeconomic Developments and their Impact on Credit Supply

2.1 Romania has one of the lowest GDP per capita among EU accession countries, representing about a quarter of the EU-15 average in 2002 in purchasing power standard (PPS) terms. However, the country has experienced rapid growth rates in recent years (around 5 percent during 2001-2003 and probably above 7 percent in 2004.) Exports through 2003 and domestic demand in 2004 have been the main contributors to this expansion.

2.2 Rather high current account deficits (5.8 percent of GDP in 2003 and probably well above 6 percent in 2004) and high, albeit declining, annual inflation rates (11 percent in 12 months through September 2004 compared with a 9 percent target at end-2004) have led to tight financial conditions in Romania. Thus, the overall government deficit is set to decline from 2.3 percent of the GDP in 2003 to less than 1.6 percent in 2004, while the monetary policy of the National Bank of Romania (NBR) is very restrictive: the NBR rate for attracting deposits from banks stands currently at 18.75 percent p.a., and reserve requirements have been set at 18 percent for banks' liabilities in local currency and 30 percent for liabilities in foreign currency with a maturity shorter than 2 years. Consequently, banks are interested in foreign exchange resources with a maturity significantly longer than 2 years, typically 5 years or longer. If the Facility is granted for 7-10 years, the banks will stand ready to take part.

2.3 In spite of large external deficits, the domestic market has recorded a significant surplus in foreign exchange, thus triggering a remarkably stable exchange rate (at end-September 2004, the Euro was practically flat, compared to end-2003; the real appreciation of the Leu against a basket consisting of 75 percent EUR and 25 percent US$ was 6.1 percent at end-September 2004 compared to end-2003) and surging reserves of the Central Bank. Under such circumstances, it appears that fundamental factors lead towards continuing appreciation of the local currency and credit in foreign currency is increasingly appealing for domestic users. In this respect, the Facility follows the market tendencies.

2.4 A large and rapidly growing number of Romanian citizens work abroad, mostly in EU countries. They total more than 2 million people (about 20 percent of the labour force) and they send considerable amounts of money to their country of origin. The balance of payments in 8 months of 2004 has recorded €1.2 billion under "other current transfers", 38 percent higher than in the similar period of 2003. It is likely, though, that official statistics understate the level of such transfers. An indication of this is given by the level of "errors and omissions", which displays net inflows in excess of €950 million. At this magnitude, the phenomenon has important macro- and micro-economic implications. For the purpose of our topic, it is worth noting that a significant part of remittances reaches small cities and rural communities and provides financial resources for both the existing and start-up business opportunities of their inhabitants. Although no relevant study has not yet been carried out, anecdotal evidence shows that remittances are used first for home appliances, second for restructuring or construction of new houses, and third for starting some sort of local business. Therefore, the ground for new economic activities in rural areas is already set and additional external financial resources, such as the Facility, are expected to have a good catalytic role.

2.5 In October 2004, the European Commission acknowledged that Romania had a functional market economy and restated the year 2007 as target for the country's accession to the EU, together with Bulgaria. This political decision has very important implications on developments expected in the years to come. It is likely that both financial inflows and foreign direct investments (FDI) will grow. However, their territorial distribution will remain uneven and rural communities will benefit much less from that trend. Therefore, there are good reasons to draw in advance the main characteristics of the Facility and eventual similar future rural credit facilities, whose scope and further downscaling could be gradually widened. The issue is discussed in Chapter 4.

2.2 Commercial Banks

2.2.1 Overview

2.6 Banks are by far the strongest player in the Romanian financial system. They have a good legal framework – fully in line with EU standards – and their prudential indicators are way above the minimum requirements, which are, in their turn, more demanding than those prescribed by the Basel Committee. Basel II standards are set to enter into force by next year. There are 30 banks and 8 branches of foreign banks operating in Romania. The top 5 commercial banks gather 61 percent of the total assets in the banking sector, while majority foreign-owned banks account for some 60 percent of the total assets in the banking sector.

2.7 Throughout the period since 1990, high and volatile inflation has led to the lowest monetisation and financial intermediation among EU accession countries. Thus, in December 2003, money supply and non-government credit represented only 24.4 percent and 16 percent of the GDP respectively – lower than in any other accession country. Due to this fact, the supply of financial services is somehow weaker than the potential demand for such services. The rules of the game are basically set by banks, which are selective in choosing their clientele and most of them are reluctant to spread out their activities to rural areas. An exception is represented by those banks with plans for an aggressive expansion of their activity and for better positioning in a market perceived as having a promising potential.

2.8 Credit to non-government, in particular consumer lending, expanded rapidly during the last couple of years, confirming the catching-up trend. Real growth was 50 percent in 2003 and another 19 percent in 8 months of 2004. Such an expansion stretches banks' administrative, human and financial resources close to their limits and, to a certain extent, diminishes the interest in the new Facility.

2.9 Bank lending terms are unfavourable to borrowers. Interest rates are high (the average lending rate currently exceeds 26 percent p.a. for domestic currency credit), collateral requirements are tough (normally, mortgage is required at a value that may represent 250 percent of the loan value) and they significantly increase the overall cost of borrowing from banks. Credit in foreign exchange is preferred both by lenders (who get this source of money from abroad and transfer the exchange rate risk to the borrower) and borrowers (since the nominal interest rate is significantly lower, while the perception of the exchange rate risk is low.) This type of credit represents more than 60 percent of the total non-government credit.

2.10 By maturity, short-term credit (up to 12-months) accounts for 52.5 percent in local currency and 43.5 percent in foreign currency; medium-term credit (1-5 years) accounts for 43 percent in local currency and 35 percent in foreign currency, and the balance (4.5 percent and 21.5 percent respectively) is long-term credit with a duration of more than 5 years. One of the main reasons for the under-representation of long-term loans is the mismatch in resources; therefore, banks are interested in attracting funds with longer maturities in order to diversify their loan portfolio. In fact, in recent years, most banks have used external resources for their loans, extended by their parent foreign banks or with their parent bank support, at very competitive terms. Therefore, banks are cost conscious and selective in attracting new external sources as well.

2.11 Striking differences between banks can be detected. In general, larger banks apply somewhat better lending rates and offer a wider choice of loan products, including credit with longer maturities, but smaller clients complain that they are not treated well, and large banks are far from acting like a business partner. Small banks, on the other hand, tend to treat their clients better, but charge normally higher lending rates and typically do not offer long-term loans for investments, because they have less resources available and insufficient expertise in term lending.

2.2.2 Bank Credit to Rural SMEs: Too Many Constraints

2.12 Lending terms are even more unfavourable for SMEs, particularly those in smaller rural communities, where banks have either no network of branches or agencies or a very limited one; typically, additional interest rate margins are charged to rural customers, and the evaluation of loan collateral is very conservative. Few rural SMEs dare to apply for bank loans and even fewer are successful in receiving loans. In July 2004, credit to agriculture, forestry and fishery represented a mere 2.6 percent of total loans above €5,000 that were extended by the banking system. It is true that rural credit covers more than just agriculture, but the overall picture does not change significantly. Therefore, the usefulness of the Facility would be jeopardised if it were limited to new bank customers only and not extended to include existing clients who are seeking first time term loans for restructuring and expanding their current business activities, or diversifying into new activities.

2.13 Several reasons and conditions concur to give rise to the under-representation of rural credit in the overall loan portfolio of banks. First, the banks’ presence in smaller communities is weak. For profit considerations, but also because large cities offer plenty of business opportunities and room for expansion, banks are reluctant to open new units in rural areas. Transaction costs of banks in rural areas are high without being compensated by correspondingly high revenue levels. While bank automation may reduce staff costs, it also increases the required equipment and communication costs. The bottom line is reached when the total costs of operating a small retail bank outlet with a low volume of operations are not offset by their earned income, which limits the interest of banks in this type of activity. It is a fact that banks who inherited a large branch network keep shrinking their presence in small communities (as is the case with Raiffeisen Bank, as well as with Banca Comerciala Romana and BRD-Groupe Société Générale). It is worth mentioning that attempts to reverse this trend have met with little success, so far. Thus, the World Bank Rural Finance Project, launched in 2001, has earmarked an important amount of almost

US$17 million out of a total WB loan of US$80 million for financing the expansion of banks into small communities and enlarging the network of retail bank units. There have been, however, just two applications from banks to access that component. One of them, Banca Transilvania, intends to develop its infrastructure in smaller communities, while the other (Banca Carpatica) only plans to purchase and install ATMs.

2.14 Second, from the experience of earlier decades, which has not been changed by developments over the last 15 years, bankers continue to believe that rural clients in general, and farmers in particular, have little financial discipline and normally do not have the capacity to repay their loans. Besides, providing credit services in rural areas is problematic. An evaluation of the creditworthiness of a potential borrower can hardly take place 50 km away from the location of the loan applicant, so banks simply choose to decline the transaction.

2.15 Third, the culture to work with a bank is limited in rural communities. Thus, according to "The Rural Euro-barometer", 67 percent of the rural population have little, very little, or no trust at all in banks, and only 20 percent trust them much or very much; 9 percent of rural families hold a bank account and only 5 percent of families have a family member with a bank card; a mere 0.2 percent of the rural population works in a financial institution or insurance company. Therefore, the limited presence of and lack of familiarity with banks and bank products in rural areas is mirrored by the lack of trust in using bank services.

2.16 Fourth, assuming that entrepreneurs in rural areas are able to overcome the widely spread lack of trust in banks, potential borrowers still have huge difficulties in meeting banks' tough conditions to get a loan. On the one hand, high real interest rates and short grace periods exclude many eligible investment projects right from the beginning due to insufficient profit rates and/or uneven cash flow. With interest rates exceeding 15 percentage points p.a. in real terms, few projects in rural areas are able to qualify and prove their profitability and repayment capacity in advance. To a certain extent, foreign currency loans offer somewhat better conditions, in particular for investment projects, but a critical consideration in this case must be that no disruptions in the exchange rate will take place over the duration of the loan. On the other hand, collateral requirements are very demanding. In most cases, mortgages on real estate assets are the preferred collateral. Valuation of assets is usually extremely conservative, land in rural areas is not accepted, the ratio between the loan value and the replacement value of the collateral can easily reach 1:4, and the costs of evaluation and notary registration are also high. Such features add on to the costs of credit and to the discomfort of potential borrowers.

2.17 Fifth, assuming that all the constraints listed above are overcome, drafting a business plan and submitting a loan application file according to the banks' demanding requirements are often beyond the capability of common rural entrepreneurs. Surveys, as well as own findings of the FAO team, show that the larger the bank, the lower the interest rate on loans, but also the less friendly the behaviour of the bank towards potential clients.

2.18 The above-mentioned constraints are valid for all rural businesses, but agriculture, with its assumed high risks, is by far the most disadvantaged. The fact that "Banca Agricola", which was most exposed to agriculture, ended up on the brink of bankruptcy and had to be supported with a massive last-minute capital bailout by the government before privatisation and take over by the Raiffeisen Bank contributed to this attitude. Moreover, bankers generally have a rather limited knowledge of the agricultural sector, which impacts on their ability to appraise farmers' loan applications. Banks therefore remain reluctant when it comes to getting involved in financing agriculture.

2.2.3 Banks' Interest in the Facility

2.19 The FAO team met with representatives of 6 banks that may be interested in the new facility. They were selected from among the banks with a good track record of cooperation with the EBRD, a sound financial standing, and lending experience with SMEs. These banks are: the **Romanian Commercial Bank (RCB)** (the largest bank in the country, which is in its first stage of privatisation as supported by the EBRD and which has a high exposure to the EBRD but at the same time also has a high equity base); **Banca Romaneasca (BR)**; **Alpha Bank (AB)**; **Robank (RB)**; **Banca Transilvania (BT)**; and **Miro Bank** (in the last two, the EBRD is a shareholder). Some main issues discussed with the banks are presented in **Annex 1**. Although the Romanian Banking Association (RBA) stands ready to organise a meeting with representatives of other interested banks, the limited initial size of the Facility does not seem to make it necessary to carry out such an initiative immediately.

2.20 All the interviewed banks expressed their interest in the Facility, being prepared to negotiate specific conditions with the EBRD. The reason for this interest varies from one bank to another. Thus, the largest bank, RCB, is interested in international lending resources to complement other investment schemes that it co-finances (notably SAPARD) and in receiving TA and support for training of additional staff in dealing with SMEs. Banks with a strong foreign parent owner (as with AB) are interested in increasing their visibility in the Romanian market, while smaller banks (RB and MB) find it a good opportunity to expand their business in rural communities and/or to develop investment financing schemes. All banks, except BR, are interested in receiving training support and TA for developing specific procedures in order to deal with the type of credit and clients envisaged by the Facility, while BR stands ready, based on its experience, to bid for becoming technical assistance provider to other financial institutions in this field.

2.21 Some banks openly expressed their interest in a comprehensive set of procedures to assess the creditworthiness and bankability of investment projects of rural SMEs, since their expertise is rather poor in that particular field. Ideally, such procedures should include developing credit scoring models in order to improve the loan application appraisal and loan approval process.

2.22 The banks would envisage a Facility with little, if any, strings attached. In particular, they intend to also be able to finance land and building purchases, to finance both investment and working capital, to pre- and co-finance other schemes such as SAPARD, and to have full decision-making power over the projects they choose to finance. The suggested loan size range of between €15,000 and €200,000 is considered acceptable but should be seen as indicative. The possible loan volume is seen as ranging between €3-10 million per individual bank, subject to further negotiations regarding the specific terms of the Facility.

2.3 Other Financial institutions

2.3.1 Leasing Companies

2.23 The potential interest of leasing companies in the new facility was tested out with the "Association of Leasing Companies in Romania" (ALCR), which consists of 34 leasing companies that hold some 56 percent of the total leasing market in the country. The association is a member of "LEASEUROPE", an acronym for the "European Federation of Leasing Company Associations". According to ALCR, the fast-growing Romanian leasing market will reach some €1.8 billion in 2004. However, car leasing is the main leasing activity so far. Potential SME clients in rural areas look at leasing finance of machinery and equipment investments as an attractive alternative to bank lending due to the serious constraints that they face in complying with bank loan collateral requirements.

2.24 The response of the leasing companies to the prospect of participating in the Facility was not over-enthusiastic. One of them (**Romexterra Leasing**, fully owned by the Banca Romexterra) eventually developed an interest and it mentioned agro-tourism as a potential sub-sector in which it could get involved. Assuming that the EBRD wants to diversify the financial intermediaries that will take part in the Facility, further discussions should be held, primarily with leasing companies owned by banks. Possible candidates who the EBRD may want to contact include Unicredit Leasing and Motoractive, with whom the WB Rural Finance Project works, and the various leasing companies who already receive finance from the EBRD as well as participating in the EU/EBRD SME Credit Facility, Phase II. They are more likely to be able to meet the eligibility standards required by the EBRD, although their current exposure to international credit funds may be too high.

2.25 Leasing companies would be a good alternative for those SMEs who are interested in purchasing new equipment, since leasing procedures are quite streamlined and collateral requirements are not a main problem (most leasing companies would accept the equipment itself as the sole collateral). The new Facility offers the additional advantage that it can be extended for periods longer than 3-4 years – typically the duration of a leasing contract. The FAO team is of the view that the Facility should explicitly exclude private car purchase from the EBRD rural credit utilisation, but leasing of the business transportation means of SMEs would be eligible.

2.4 Micro Finance Institutions (MFIs)

2.4.1 MFIs in Rural Areas

2.26 In recent years, non-governmental organisations (NGOs) have become more numerous, and their fields of activity have widened. Some of them are, in particular, engaged in rural development. There are no overall surveys of NGOs that provide rural credit and which quantify the total disbursed loan amounts and the regions serviced. However, eight NGOs out of a total bidding list of 34 NGO/MFI Service Providers were short listed by the WB Rural Finance Project and of those, three have already started their operations under the project. A brief presentation of those three MFIs follows:

- **CAPA Foundation Romania** has been operating since 1997. Rural loans (about 25 percent of the total loan portfolio) include loans for livestock purchase, vegetables for sale, cereal crops (maize and wheat), reconstruction of buildings (stables, houses) and purchase of equipment. Besides rural lending, the NGO provides training and advisory services to clients for the development of their business and management skills. While start-up capital was provided by the international NGO, World Vision, most of the capital used by CAPA has been acquired at market interest rates. The foundation has shown an outstanding capability to adapt to and to work under commercial conditions. Future plans include, besides expansion in traditional activities, the setting-up of a separate financial company to which the lending operations will be transferred.

- **CHF International** (Community Habitat Finance) has been operational since 1994 with a mission mandate of community enhancement, economic growth and micro finance development. It currently operates in 19 counties, most of them located in the western and the central part of the country and by end-2004 it plans to expand in 6 other counties, located in the south-east region. It has an outstanding loan portfolio of some US$5 million. Capital sources include USAID (since March 2003 CHF has been managing a five-year, US$13.3 million programme for SMEs in Romania. Both up to 2-year standard business loans with a maximum size of up to US$20,000 and short-term loans, up to 3 months and maximum US$5,000 can be provided), Overseas Private Investment Corporation, and the Romanian American Enterprise Fund. CHF appears interested not only in widening the scope of its micro-credit activity, but also in contributing to an adjustment of the legal status of MFIs, in order to transform them into market-based companies, specialised in financial intermediation.

- **The Centre for Economic Development** (CDE) is a Romanian non-governmental organisation, member of the Soros Open Network in Romania. Its main objective is to provide SMEs with a one-stop shopping place for information, business development services, financial services and related support services which facilitate the start-up, development and expansion of business activities. Since the inception of its micro-credit operations in 1999, CDE has set up a network of 38 local village groups with over 1,965 members. These groups are used as intermediaries for the implementation of the credit programme. The programme focuses on expanding the creation of retail financial intermediaries at village level, the so-called “Rural Development Associations” (RDAs) for the disbursement of small loans. RDAs are responsible for selecting their members and leaders with basic guidance provided by CDE staff. This self-selection process has proven to be effective in ensuring a good screening of group member loan applicants – a fundamental task in the loan appraisal process of any type of lending programme. Group members share a joint liability for loan repayments.

2.27 The importance given in all the above cases to community enhancement deserves special mention here. Involvement of communities in sustaining and fostering local economic development has proved to be beneficial. The most successful MFIs have become market niche players who provide a missing link in the relationship between commercial banks and rural households and/or micro and small enterprises.

2.28 Most of the active MFIs succeed in reaching low loan default and very high repayment rates (reportedly above 97 percent.) They typically charge high interest rates (that could exceed 18 percent p.a. for dollar loans) for loans ranging from US$700 to US$10,000, but their collateral requirements are much less stringent than those of banks, and clients perceive MFIs as their business partner and in many cases they are reluctant to switch from MFIs to banks in order to meet their expanding financing needs.

2.29 Due to their limited financial resources (each MFI holds own funds of around US$5 million and borrowed funds that do not exceed US$10 million) most MFIs have not yet reached their breakeven point. However, they keep improving their performance and appear close to becoming profitable entities. Critical points are the legal status of MFIs, their capital base and the continuity of their international funding sources.

2.4.2 MFIs' Potential Role in the Facility

2.30 At this juncture, MFIs do not qualify as financial intermediaries for the Facility. On the one hand, their legal status and funding basis are rather uncertain, especially if we consider the long-term horizon of the Facility; on the other hand, MFIs typically handle projects with lower individual loan values than envisaged by the Facility and which fall under micro-credit activities.

2.31 However, they could connect banks with SMEs as potential borrowers and also provide TA to entrepreneurs to develop business plans and to prepare the required documentation for loan applications. Such SMEs could be current or former borrowers of MFIs who are graduating to become bank clients for larger and longer maturity loans or other SMEs that the MFIs have met as part of their programmes in rural areas. Against a reasonable fee, possibly covered from the non-reimbursable TA component of the Facility, MFIs could be used for establishing the crucial relationship between SME clients and banks and they could also serve as a marketing agent for the Facility. That possible role was brought up by the FAO team with the country director of CHF, who appeared very interested in the concept. The issue will be further discussed in Chapter 4.

2.5 Credit Guarantee Funds: The Rural Credit Guarantee Fund (RCGF)

2.32 The credit guarantee funds function is based on the risk sharing principle. Their goal is to facilitate the access to credit by SMEs and to protect banks against loan default – a risk perceived as high – when crediting SMEs. There are 3 functional guarantee companies in Romania, all of them set up with assistance from IFIs, namely: the Romanian Loan Guarantee Fund for Private Entrepreneurs (RLGF) established in 1993; the Rural Credit Guarantee Fund (RCGF) established in 1994; and the National Loan Guarantee Fund for SMEs (NLGFSME), whose activity started in 2002.

2.33 The most important IFI for the topic in discussion is the RCGF, operational since 1994. It was established as an attempt to resolve one of the key problems in the financing of agriculture: the limited ability of farmers to provide bank loan collateral. Besides the subscribed capital owned mainly by three commercial banks, the Fund's resources come from an €9 million grant contribution of the European Union as part of the PHARE programme, together with accrued interest (equivalent to more than €3 million). The Fund guarantees investment loans up to 70 percent of the loan principal (up to 50% for working capital loans), based on the applicant's business plan, once it is approved by the lending bank and the RCGF. The Guarantee Fund does not require collateral from the borrower, but it receives a commission fee from the bank which is charged to the borrower. For private farmers and farmer associations, the commission fee is borne by the Fund from the interest accrued on the EU grant.

2.34 This is a welcome mechanism, because one of the main reasons why agricultural lending from banks is not attractive to either farmers or banks is the limited ability of the borrower to meet the bank requirements for conventional collateral. In addition, the structural design of the RCGR has a number of features that guarantee its viability. Of these, two are especially important:

- While the Fund guarantees a major part of the loan principal, this share does not include the collateral provided by the borrower or the foreclosed guarantees by the bank in the event of loan default. Consequently, the bank shares a significant part of the risk and accordingly is expected to perform a thorough appraisal of the loan application.

- The procedures used to appraise loan applicants are clear and relatively simple, thus reducing the amount of work per application and allowing the Fund to operate as a central unit. The same can be said for the guarantee settlement with the financing bank in the case of a bad debt. In conclusion, the Fund's operational costs are modest and they will further decrease, if the activities of the RCGF continue to grow.

2.35 Up to 2002, the number of guarantees remained at a modest level overall, and the Fund's role was marginal. However, starting mid-2002, an improvement in the conditions provided for guarantees led to a higher attractiveness for banks. A sizeable increase in guarantees has been registered since then. Thus, in 2003, the total annual ceiling of guarantees was set at €37.5 million (three times the level in 2002), while the actual amount exceeded €44 million, almost 6 times the actual number of guarantees granted in 2002.

2.36 There are two drawbacks to the Fund's capacity to provide guarantees for new investment loans in rural areas:

(a) The outstanding amount of credit guarantees is quite close to the prudent limit that can be used by RCGF on the basis of its own capital and the EU grant, so most of the new guarantees are extended when old guarantees mature. Ideally, private entities and possibly the EU should increase the resources that the RCGF is able to manage.

(b) The RCGF does not extend guarantees for industries other than farming and agro-processing. Therefore, a good chunk of new investments expected in rural areas is not eligible for the RCGF guarantees. In the best case scenario, additional funding would also enable a widening of the scope of the current Fund's uses to all rural economic activities.

2.6 Lessons from the World Bank Rural Finance Project

2.37 The World Bank (WB) Rural Finance Project provides a good experience whose general conditions for credit are not very different from those intended by the Facility. The WB loan is extended to the Romanian Government for 12 years with an 18-month grace period (The same conditions are transferred to participating on-lending banks), at 6-month LIBOR plus 90 basic points and an up-front fee of 1 percent of the loan. Banks and other lenders (leasing companies and micro finance institutions) on-lend the credit resources to final borrowers using their normal loan appraisal procedures, while they apply market-based lending rates.

2.38 There are a number of embodied restrictions in the scope of the credit and the disbursement procedures: the credit cannot be used to purchase land or buildings; tobacco, alcohol, and environmentally damaging industries are not eligible; loan applications in excess of US$500,000 need to be reviewed first by the WB prior to approval; the final borrower has to observe the WB procurement procedures for loan contracts exceeding US$1 million. However, new Greenfield investments, co-financing and pre-financing of private investment projects benefiting from other financing schemes such as SAPARD, as well as working capital finance, are all eligible under the WB rural credit and leasing component.

2.39 The overall WB project loan agreement, an amount of US$80 million, was signed back in 2001. The initial procedures included the Raiffeisen Bank as "treasurer bank", whose simultaneous position as Project Implementation Unit entitled it to get confidential information from other banks, thus favouring it in competing on the same market. Under such conditions, all potential participating banks declined their involvement. In September 2003, the whole mechanism was revised: a Project Management Unit (PMU) was created in the Ministry of Public Finance, the Raiffeisen Bank kept only the treasurer bank function and the definition of "rural" was significantly widened, implying that everything is rural except 12 large cities (rural economic activities and enterprises as well as individual beneficiaries are eligible for rural credit and leasing in communities up to 200,000 inhabitants, while support to new retail bank units is eligible in localities up to 100,000 inhabitants). Both existing as well as new bank clients can benefit. Disbursements started in 2004 for 3 participating banks (Banca Romaneasca, Robank, and Banca Transilvania), 2 leasing companies (Unicredit Leasing and Motoractive Leasing), and 3 MFIs (CED, CHF International, and CAPA Foundation Romania). Two other banks (Carpatica and Ion Tiriac) applied recently for their inclusion among participating banks.

2.40 One year after the recalibration of the programme, around 40 credit projects through banks and some 1,400 micro loans through MFIs with a total amount of just US$11 million have been disbursed. While the programme appears to have been gathering pace in recent months, the idea of a one-year extension (initially the WB loan was scheduled to be fully disbursed and closed by end January-2006) appears most likely.

2.41 The performance of the WB rural finance project has been weak and this might suggest that rural business has a limited capacity to absorb loans. In fact, slow absorption is due to the general constraints discussed in section 2.2 above, which were not addressed in the specific design of the project, while participating banks have limited branch networks. Besides this, the WB has imposed additional steps before banks can access the credit, thus adding on to the period of time between loan applications and loan disbursements. Such constraints should be avoided in the design of the Facility in order to increase the likelihood of well-timed disbursements. Suggestions in this respect are discussed in Chapter 4.

2.7 SAPARD

2.42 SAPARD (Special Accession Program for Agriculture and Rural Development) is a special financial support scheme offered by the EU to the 10 accession countries of Central and Eastern Europe, which enables them to make structural improvements to their agricultural and rural environment. The legal basis was established by several initiatives that were adopted by the European Commission in 1999 and 2000.

2.43 SAPARD support is to be granted in accordance with the national agricultural and rural development programme of the applicant country during the period 2000-2006, on the basis of the principles which apply to EU Structural Funds. The content of each country’s programme reflects the priorities established by the national authorities and depends on the needs of each country within the limits set by the basic Council Regulations. It is worth noting that, whereas other pre-accession programmes such as PHARE and ISPA have at least some key instruments managed by the Commission, this does not apply to SAPARD, not even for project selection.

2.44 SAPARD offers candidate countries the possibility of funding projects in the following areas, the so-called “Measures”:

- Investments in farms;
- Improvements in the processing and marketing of agricultural and fishery products;
- Improvements in the structures for veterinary and plant health control, the quality of foodstuffs and consumer protection;
- Agricultural production methods which are designed to protect the environment and to preserve the countryside;
- Development and diversification of rural economic activities, leading to multiple economic activities and alternative income sources;
- Establishment of farm relief and farm management support services;
- Creation of producer associations;
- Renovation and development of villages and the protection and preservation of rural heritage;

- Reclamation of land, consolidation of farm parcels, development and updating of land registers;
- Improvements in vocational training;
- Development and improvement in rural infrastructure;
- Management of agricultural water resources;
- Forestry development, including forestation of agricultural areas, investment in forest holdings owned by private entities, and the processing and marketing of forestry products;
- Provision of technical assistance for the measures covered by EC Regulation No. 268/1999, including studies, assistance in the preparation and monitoring of the programme, and support with information and publicity campaigns.

2.45 The main objectives of SAPARD are to assist the agricultural and rural sectors in the accession countries to become more competitive within the context of increasingly open global trading regimes and to develop new strategies which aim at promoting the economic development potential of rural areas.

2.46 Romania will receive from the EU during the 7 years of the SAPARD programme a total of €1,072 million, or more than €153 million[1] on a yearly basis, in the form of non-reimbursable funds, which will be distributed as grants to co-finance investment projects in agricultural and rural development. The Romanian Government will supplement this amount with a total contribution of about €350 million over 7 years or about €51 million per year (25 percent of the eligible EU and Government financing). Financing of private investment projects takes place through a combination of investors' own and borrowed bank funds (50% of the total investment costs) and SAPARD grant funds (the remaining 50%, of which the EU provides on average 75 percent and the government 25 percent). Public investments, on the other hand, such as in the case of rural infrastructure, may benefit from a 100% EU/Government grant funding, provided the project is not substantially income generating.

2.47 The SAPARD Agency in Romania, whose official accreditation took place in 2002, as a public institution subordinated to the Ministry of Agriculture, Forestry, and Fishery (MAFF), is the authority charged with the financial and technical implementation of the SAPARD programme. The Agency has two functions: (i) to implement the "Measures" under the programme and (ii) to make payments to beneficiaries. The Agency headquarters is in the MAFF and it has 8 Regional Offices in Iasi, Alba-Iulia, Craiova, Timisoara, Constanta, Satu Mare, Targoviste, and Bucharest. A comprehensive set of rules and procedures has been defined, which aims at ensuring full transparency and establishing an level playing field for all potential beneficiaries.

[1] Considering that the programme funds of EUR 1,072 million are available for a period of seven years, but are actually spread over a shorter implementation period, it is assumed that the annual amount will exceed EUR 153 million.

2.48 While the procedures may be perceived as overly bureaucratic, they represent an obvious occasion to set general rules rather than deciding on the specific allocation of funds. Moreover, the SAPARD programme is an important step forward for improving capabilities at both individual and institutional level. Written manuals are supposed to establish clear and comprehensive procedures for the separation of duties, carrying out of controls before projects are approved (appraisal procedures), compliance with public procurement procedures, carrying out of physical reviews, authorising and verifying payments, keeping payment records of the SAPARD programme, system control, exerting internal and external auditing, supervisory activities, and reporting and monitoring procedures.

2.49 The actual performance of the SAPARD programme implementation has been mixed, so far. More than two years since the SAPARD Agency was set up, the capacity to absorb EU funds is proving to be rather low. Thus, only in October 2004 did the authorities announced that funds earmarked in the programme for 2000, amounting to €204 million, had been completely disbursed, less than three months from the moment when unused funds would have been cancelled. The reasons for this situation range from limited capacity to identify viable projects and to draw a business plan according to the EU tight procedures, to reported cases in which the access to funds was unduly conditioned to the use of a certain consultancy agency, which overcharged the potential beneficiary of non-reimbursable funds. Even in well documented cases and complete observance of the required conditions, beneficiaries of funds complain that disbursement is painfully slow (can take up many months), and timely business investment opportunities are thus missed. Interviewed rural SMEs complained that SAPARD is mainly meant for banks and foreign investors and that larger projects are preferred. For instance, the measure to improve agricultural processing and marketing has a minimum eligible financing amount of €30,000 but the ceiling is up to €2,000,000.

2.50 Such drawbacks notwithstanding, SAPARD remains a huge opportunity to develop rural areas. Banks, NGOs and other institutions provide complementary support to potential users of the SAPARD programme and recent acceleration in disbursing funds is detectable. The Facility may complement SAPARD-financed investment projects with pre- and co-financing funds from banks. Such projects have the advantage of thorough screening and thus offer a higher likelihood of loan repayment. As pointed out above, the overall envelope of the SAPARD programme is very large indeed. Moreover, in 2005 and 2006 it is also expected to disburse part of the total amounts that were earmarked for previous years and have not yet been utilised. Thus, most funds earmarked for 2001-2003 are yet to be disbursed, and financing for 2004 has not even started. The new EU/EBRD rural credit facility represents just a small fraction of the total amount expected to be disbursed in 2005 from SAPARD and, therefore, the absorption capacity for the Facility credit funds appears not to be under question.

2.8 Other Experiences in Agricultural and Rural Credit

2.8.1 The IFAD Apuseni Mountain Development Project

2.51 This 5-year rural development project with a total IFAD loan contribution equivalent to US$16.5 million, which became effective in November 1999, has a revolving credit fund component for the financing of a range of improved individual farming activities and village-level based community enterprises. The project started slowly and a subsidiary loan agreement with a commercial bank, in this case the majority state-owned BCR, was not signed until August, 2000.

In general, serious problems and long delays were experienced in the project implementation due to difficult coordination and communication with the different stakeholders, restrictions to government budget contributions, centralised project management, multi-facetted constraints encountered in mountainous areas, unfair competition with government-subsidised agricultural credit programmes and a limited experience of BCR in dealing with small-scale rural lending.

2.52 Although performance has picked up somehow in 2002, IFAD has found out that the management of a credit fund through a bank, in particular a state bank, is not the best way to reach potential borrowers in disadvantaged rural communities in Romania. A major problem of bank lending in rural areas is that small farmers are not able to comply with the conventional collateral requirements of banks and available assets like farm homes and land are either not evaluated at all or only at a very low market value. Inadequate attention was also given to the provision of TA both to BCR in assisting the bank to reach down to small-scale rural borrowers as well as to small farmers in the preparation of viable loan applications. Based on this project experience, IFAD has shifted its development focus in Romania to the promotion of local initiatives such as by providing support to the organisation of farmers associations for collective marketing of their produce. Moreover, the IFAD Apuseni project has adopted an alternative rural lending approach by collaborating with the Economic Development Centre, a NGO-based micro finance institution in Romania which has piloted with group-guarantee lending. This lending methodology has been used in the IFAD project area for the financing of village-level based community enterprises.

2.8.2 The German - Romanian Fund

2.53 On the basis of a loan agreement contract with KfW, Banca Carpatica is managing an €2.3 million credit line for SMEs as part of the German-Romanian Fund. The maximum loan amount is €60,000 and loans are offered both in foreign and local currency.

2.54 Carpatica, a new and fast growing and, in the view of the FAO team, a somehow risky bank (A Romanian business man without a banking background is the majority single shareholder), has 41 branches and operates in Bucharest and various towns throughout the country. Last year, KfW carried out a study on the supply and the demand for rural credit (which study was not shared with the FAO team) and, presently, Carpatica is carrying out a pilot rural credit project in Sibiu and two other cities. KfW has made available a total of €8 million and some 25% of that amount seems to have been disbursed already. Rural loans up to €10,000 can be provided (the average loan size is €7,500), both to SMEs (only existing enterprises with no financing of start-ups) and physical persons as final borrowers.

2.55 Recently, Carpatica has also applied for participation in the WB Rural Finance Project, which request is under consideration.

2.8.3 Miro Bank

2.56 The background of the Miro Bank is a NGO-based micro finance institution that in mid-2002 was transformed into a bank; the bank has as international shareholders: IPC, Commerzbank, DEG, KfW, EBRD and IFC. The number of staff, branches, general banking services, savings/deposits and the volume of lending operations, including to SMEs, have expanded rapidly. Notwithstanding an initial focus on urban areas, the experience as a MFI make this bank well suited for lending to SMEs in smaller cities and rural areas. A study on the demand for rural and agricultural credit was carried out in September 2002 and the bank started a pilot rural lending project at the beginning of 2003 in Timisoara.

2.57 During the pilot phase both working capital loans and investment loans were granted and the loan size was gradually increased from as low as €2,500 up to a current ceiling of €50,000. Agricultural and micro rural loans are provided to small farmers and micro-enterprises, the majority of which have an individual as the single owner: with loans up to €10,000, 2-year loan duration, interest rate of 35% on loans nominated in local currency, and acceptance of pledges on movable assets plus personal guarantors as loan collateral with no requirement of mortgage. On the other hand, rural business loans are provided to larger farmers and rural SMEs: with a loan size from €10,000 up to 50,000, 5-year maturity, interest rates between 10-16% on foreign currency loans, use of 70% mortgage as collateral for loans above €25,000, and a flexible loan repayment schedule based on the projected cash flow of the SME.

2.58 Micro and SME loans each make up about half of the total loan portfolio, but the first account for 80% and the second for 20% of the total number of borrowers. In the meantime, the Miro Bank has become profitable in the last two months and it is scheduled by November to take the name of Procredit, as similar banks in a number of other East European countries, including Bulgaria. The bank would qualify thus for the new EU/EBRD Facility. The total number of loan officers in September 2004 was 67, of whom 4 were agricultural and 7 combined agricultural/rural loan officers. The total outstanding agricultural loan amount was about US$1.2 million (250 loans) and the outstanding rural loan amount was US$1.5 million (45 loans); this on a total of near 10,000 outstanding loans of the bank.

3. ASSESSMENT OF THE DEMAND FOR CREDIT BY RURAL SMES

3.1 SME Sector and Rural SMEs in Romania

3.1.1 Main Features of SMEs

3.2 The Romanian definition of micro, small and medium-sized enterprises is broadly in line with the one used by the EC, although turnover is defined more restrictively: up to €8 million versus up to €40 million for medium-sized enterprises as defined by the EC. The Romanian authorities argue that this is more realistic considering the economic conditions in Romania:

Definition of the enterprise size	**Micro**	**Small**	**Medium**
In Romania			
Maximum number of employees	< 10	<50	<250
Maximum total turnover in million Euro	<8	<8	<8
Maximum capital voting rights held by non SME shareholders	25%	25%	25%

3.3 An analysis of the composition of enterprise registrations shows that micro-enterprises dominate the sector. In 2002, the National Institute of Statistics (INS) reported in total 343,148 active SMEs (including micro-enterprises), out of which 341,168 were privately owned and 1,980 were public. As shown below, about 89% of the private active SMEs are micro-, 9% are small and 2% are medium-sized enterprises. As could be expected, the largest number of micro-enterprises are found in the services sector, in particular in trade.

Economic sectors, 2002	**Total SMEs**	**Micro**	**Small**	**Medium**
Industry	65,150	51,283	9,954	3,913
Agriculture	10,540	8,770	1,492	278
Construction	17,083	13,124	2,969	990
Services, of which:	248,395	231,247	15,106	2,042
Trade	*172,815*	*161,953*	*9,948*	*914*
Tourism	*2,600*	*2,120*	*353*	*127*
Transportation	*15,867*	*14,363*	*1,214*	*290*
Other Services	*57,113*	*52,811*	*3,591*	*711*
Total	**341,168**	**304,424**	**29,521**	**7,223**

Source: INS, 2003[1]

[1] Statistical data for 2003 will be available only by the end of 2004.

3.4 The SME sector in Romania is responsible for a significant share of the total enterprise activities in the economy, as indicated in the table below, showing some main economic and financial indicators by enterprise size class and by type of ownership. As can be seen, with the sole exception of exports, the SMEs account for an important part of the results of the total enterprise sector.

Main Economic and Financial Indicators of Enterprises by Size, Class and by Type of Ownership at Current Prices, in ROL billion

Size class, by average number of employees	**2002**				
	Turnover	**Gross Investment**	**Direct Exports**	**Gross Value Added (at factor cost)**	**Gross Result of Exercise**
Total enterprises Out of which:	2,670,076	411,125	282,541	579,521	4,668
Total enterprises with private majority	2,177,587	252,847	243,648	438,910	36,277
Total SMEs (0-250) with private majority	1,485,075 **68.1%**	160,128 **63.3%**	69,114 **15%**	249,590 **56.8%**	36,631 **101%**

Source: INS, 2003, Table 12.11

3.5 Moreover, the SME sector in general and micro-enterprises in particular, normally include a high proportion of entities that operate within the so-called "grey economy" and whose activities, consequently, fall outside the formal, economic data base. As a result, the actual number of SMEs is normally understated. While the INS estimated that the grey economy is equivalent to 21% of the total GDP, other independent research estimates are higher, measuring it at about 30% of the GDP. Taking the 30% ratio as being more realistic, this indicates that the total number of registered and unregistered SMEs in Romania would be approximately 445,000 entities[1].

3.6 Total gross profits of private active SMEs have increased by over 25% between 2000-2002, whereas gross profits in the agricultural sector (although representing only 2.6% of all private SMEs) have registered the highest growth of all (75%). See the table below:

[1] The estimate of the grey economy, being only 30% of the formal GDP, is low by developing countries' standards.

Gross Profits of Private Active SMEs by Economic Sector and Enterprise Size at Constant Prices (CPI), in billions ROL

Sector of the Economy	2000				2001				2002			
	Total SMEs	Micro	Small	Medium	Total SMEs	Micro	Small	Medium	Total SMEs	Micro	Small	Medium
Industry	17,678	2,919	6,446	8,312	21,996	4,786	7,079	10,131	21,230	5,666	6,121	9,444
Agriculture	1,172	336	461	375	2,098	803	693	602	2,052	1,001	581	471
Construction	6,161	774	1,971	3,416	7,756	1,792	2,499	3,465	7,692	3,161	2,115	2,416
Services of which:	37,281	17,659	13,657	5,965	46,100	25,144	14,879	6,077	47,061	30,498	11,401	5,162
Trade	*24,321*	*12,388*	*9,008*	*2,925*	*27,960*	*15,541*	*9,663*	*2,756*	*25,655*	*16,557*	*6,672*	*2,427*
Tourism	*609*	*111*	*242*	*256*	*901*	*262*	*276*	*363*	*1,234*	*596*	*292*	*346*
Transportation	*1,999*	*689*	*648*	*662*	*2,789*	*1,074*	*993*	*721*	*4,926*	*2,517*	*1,354*	*1,055*
Other	*10,353*	*4,471*	*3,759*	*2,122*	*14,450*	*8,267*	*3,947*	*2,237*	*15,246*	*10,828*	*3,083*	*1,335*
Total	**62,293**	**21,689**	**22,537**	**18,067**	**77,950**	**32,525**	**25,150**	**20,275**	**78,036**	**40,325**	**20,218**	**17,493**

3.7 With regard to the geographical location of SMEs their share varies significantly across regions and ranges from 8.3% in the West through almost 20% in Bucharest and the Ilfov County, the most dynamic region in the country.

3.8 The country economy and economic growth are dominated by large cities. In-depth studies such as the World Bank Poverty Map show that even within the same county the discrepancies are very large. For instance, Timis, one of the most dynamic counties in the western part of the country, still shows great gaps in terms of economic development and growth between Timisoara (the county capital) and the rest of the county (small towns and rural municipalities). Smaller municipalities (with up to 50,000 inhabitants) are indeed still on a very slow development path.

3.1.2 SMEs in Rural Areas

3.9 A World Bank study entitled “Financial Markets, Credit Constraints and Investment in Rural Romania”, January, 2001, using 1998 data, showed that were about 80,000 registered rural SMEs, which figure is adjusted for GDP growth and unregistered entities.

3.10 In small rural communities, normally the only economic activities that can be found are farming and services such as small trade, workshops and handicrafts. Rural economic activities should also include, however, agro-processing enterprises which are normally concentrated in agricultural areas with higher potential and larger communities as well as location-specific, non-farm rural economic activities such as wood processing, glass and ceramics, rural tourism and other rural industries. The main features of the different rural economic activities in Romania (agricultural production, agro-processing and non-farm rural economic activities) are presented below.

Agricultural production

3.11 With over 40% of the total population living in rural areas and with 15 million hectares of total farm land, agriculture is the traditional backbone of the Romanian economy. Farm households, associations and cooperatives, commercial farms and large business groups, agribusiness enterprises, agricultural producer associations and agro-processing associations employ 42% of Romania's total workforce.

3.12 The major structural problem of the Romanian agricultural sector is the marked dichotomy in farm size and the way of farming. On the one hand, there is the vast bulk of 4,759,229 small farms with an average farm size of 2.9 ha (in 2003) that own two-thirds of all arable land, have little market orientation, and produce mainly for own consumption. They could better be called peasant farms or home gardens. On the other hand, according to information from the Ministry of Agriculture, Food and Forestry[1] and based on the classification of the Farm Operations Law 166/2002, in the year 2004 a total of over 169,000 commercial farms have been recorded. Among these there are 7,700 crop farms, 30,300 livestock farms, 90 fish farms, and 91,022 mixed farms. The average size of a commercial farm is quite large: 270 hectares of crops, 134 bovine heads, 1,260 pigs and 230 sheep. Since out of the total number of commercial farms there are 1,733 large-sized farms (with more than 1,000 ha land), the majority of the commercial farms would be SMEs.

3.13 For the majority of the small farms the low capital intensity and the current state of used technology have a negative impact on their production volume, cost effectiveness and product quality. In fact, many food processing companies complain that the supply of raw materials from domestic agricultural sources is insufficient and unreliable, relatively costly (small farmers can sell their fresh or primary processed products more profitably directly to consumers) and is often of low quality.

Agro-processing

3.14 According to data from the Ministry of Agriculture, Food and Forestry there are 14,509 agro-processing companies in total, of which 99% are private. The sector employs over 240,000 people, representing 5% of the total active population, while accounting for 26% of the total gross agricultural production value and 4.6% of the GDP. For details on the agro-processing sector and the various sub-sectors, see *Annex 2*.

3.15 The number of enterprises that produce *milling, bakery, and flower products* has increased each year. At present, there are almost 6,500 enterprises, of which over 4,900 are small enterprises with private capital.

3.16 At the beginning of the transition period in 1989, 100 companies were active as industrial *fruit and vegetable processing factories*: 40 enterprises with a capacity ranging from 2,000 to 30,000 tons of finished goods per year could be classified as large processors, while 60 smaller units had a rated capacity of below 2,000 tons per year. Many fruit and vegetable processors cover the supply of raw materials from their own horticultural production, while only relatively few other farmers supply them with sizable quantities of raw materials. The enterprises have similar patterns of production and they produce a broad variety of canned fruit and

[1] Data presented in "The Sustainable Development Strategy", May 2004.

vegetables, thus foregoing the cost-reducing effects related with specialisation and economies of scale as well as the advantages of a specific favourable location (in terms of climate, soil type, specific products). In spite of the fierce competition, no attempts have been made to specialise in processing canned fruit or canned vegetables exclusively. In general, the products of processing plants are often also not properly packaged or labelled and protected: the reason is undoubtedly to minimise costs, but it could also be partly due to the lack of awareness of quality and sanitary standards.

3.17 The Romanian *wine industry* has great growth potential and could become an important sub-sector in the food and beverage industry of the country. However, the competitiveness of the wine sub-sector is low, while it faces serious problems due to numerous weaknesses along the production chain from vineyards and wineries to distribution and trade.

3.18 Hygiene is the main issue for *slaughterhouses and meat processing* plants and of all enterprises, the meat sector needs to make the most adjustments to survive during the process of the EU accession. Similarly, about three quarters of the Romanian national milk producers are not respecting the tight sanitary requirements that have been imposed. Poor milk quality is a serious limiting factor for the *dairy industry*, because of the high bacteria content that is caused by the insufficient availability of cold storage facilities and the use of unsuitable sanitation and milk handling practices.

3.19 According to data from INS, in 2002 there were 10,540 registered and active SMEs in the whole food and beverage industry, of which only 1,492 were small enterprises and 278 were medium-sized enterprises (as per the standard definition of the number of permanent employees), while the remaining major part were micro-enterprises. It can be remarked that, apart from the number of permanent employees, there are no great structural differences between small- and micro-enterprises, while INS indicators in the table below show that the most dynamic firms are the 8,770 micro-enterprises.

Food and Beverage: Private Active SMEs in 2002, Gross Profits and Gross Losses by Size at Constant Prices (CPI)

	Food and Beverage		
	Number of SMEs	**Gross profits ***	**Gross losses ***
In 2000			
Total SMEs	***6,376***	***1,172***	***2,067***
Micro	5,112	336	626
Small	1,024	461	784
Medium	240	375	657
In 2001			
Total SMEs	***7,195***	***2,098***	***2,324***
Micro	5,950	803	912
Small	1,025	693	656
Medium	220	602	756
In 2002			
Total SMEs	***10,540***	***2,052***	***4,499***
Micro	8,770	1,001	2,330
Small	1,492	581	1,070
Medium	278	471	1,098
* at constant prices (CPI) in billions ROL (based on INS, 2003)			

3.20 *Non-farm rural economic activities.* The activities of rural SMEs, however, are not limited to only agriculture production and agro-processing. Based on their specific geographical location, other rural economic activities, both manufacturing and services, are relevant. Economic activities considered in this study include: wood and furniture, glass and ceramics, textile and apparel, and rural tourism. See *Annex 3* for details.

3.21 There are more than 8,000 small- and medium-sized enterprises operating in the *wood and furniture* sector and some 85% of the wood-cutting and processing, and 95% of the furniture manufacturing companies are micro-, small and medium-sized enterprises. Most of them are located far away from the main urban areas.

3.22 As most of the forests are located in the northern and central part of the country (mainly spruce, fir, oak, beech), two regions show a high concentration of wood processing and furniture manufacturing activities: the NE area from Suceava and down through Iasi to Bacau and the NW area from Baia Mare and Satu Mare and down through Cluj to Targu Mures.

3.23 In the *garment and textile industry*, approximately 4,724 enterprises operate and· of these, 3,300 are small and medium-sized enterprises. Approximately 70% of the companies which are active in this sector are SMEs, and they employ 50-60% of the total 460,000 people employed in the sector. Currently, the majority of SMEs in the textile industry are engaged in the production of garments, as opposed to the production of textile fabrics.

3.24 According to industry experts of the Ministry of Commerce and Trade, in the combined activities of *glass and fine ceramics* there are 44 large companies, 55 small and medium-sized enterprises and 221 micro-enterprises.

3.25 In the *glass industry*, major clusters of enterprises have been developed in locations that have deposits of the required raw materials, sand and alkaline, while in former times also wood from nearby forests was used to heat the furnaces for glass-melting. These areas are in or near Targu Jiu, Buzau-Scaieni, and Dorohoi and in a number of areas in Transylvania, including Tarnaveni, Turda, Sibiu, and Medias. The largest producers of container glass, however, are located in Bucharest and Sighisoara.

3.26 In *ceramics*, the major industrial activities for sanitary and tabletop ceramic and porcelain production are located in Transylvania, specifically in Cluj Napoca, Alba Iulia, Sighisoara and further north in Baia Mare. An additional centre for porcelain production is located in Curtea de Arges. The bulk of traditional Romania ceramics are produced in four centres: Suceava, Horezu, Corunt, and Baia Mare.

3.27 The small and medium-sized enterprises in the glass and ceramics industry share the same common features:

- A *small enterprise* is owned by a former worker of a state-owned company. The plant is typically located adjacent to the owner's home and the firm may have up to 10 years of incremental growth, usually self-financed. Equipment has been bought second-hand. Export contacts are made through the Chamber of Commerce and entrepreneurs believe that attendance of trade fairs will give them better opportunities to access new markets. Managing of cash flows and energy costs are the top priorities of these firms.

– *A medium-sized company* is owned by a former manager of a state-owned company. Those enterprises operating at the smaller end of the scale may still be located on the owner's land and additional land may be available for expansion, but capital is needed for investments in buildings and equipment. The firm has successfully expanded its production capacity to meet demand; owners and managers regularly attend trade fairs; and the managers' main concerns are pricing, cost containment, and foreign competition.

3.28 In the tourism industry there are approximately 10,147 companies, of which approximately 80% are SMEs. SMEs often operate local tourism agencies, small hotels, restaurants, and "bed and breakfast" facilities. *Rural tourism* can be found in many areas of Romania but it has its major concentration in the hilly and mountainous regions and in the Danube Delta. This type of tourism provides modest accommodation in rural areas which allow for a more leisurely pace of life. Rural tourism took off only after the changes in the country, but today it can already accommodate up to 10,000 tourists, mostly in smaller family-owned boarding houses. At present, there are 4,000 of these rural and agro-tourist boarding houses. SMEs in the tourism sector have various backgrounds. In rural and eco-tourism, almost all the companies are family-operated SMEs who commenced with small amounts of own capital. Others started through the privatisation of state-enterprises.

3.2 Comparative Analysis of Specific Economic Sectors

3.2.1 Agricultural Production

3.29 Positive factors for investments and financing are:

(i) Good potential (large agricultural land area, fertile soils, cheap labour force, long agricultural tradition, in particular, in grains, vegetables and fruit), but currently under-utilised.

(ii) Importance of agriculture in the overall economy: as of 2002 the agricultural decline has stopped and the share of agriculture has gone up slightly from 11.2 % in 2002 to 11.7% in 2003. The sector employs more than one third of the total active population. Labour costs are low but so, too, is productivity.

(iii) Physical yields of durum wheat per hectare are above the EU average level and have attracted foreign investors.

(iv) In view of the EU accession, the Ministry of Agriculture, Food and Forestry, with the help of the EC, produced an agricultural and rural strategy in February 2003; main targets are to improve the economic performance, the competitiveness and the sustainable development of the sector, with the help of external and domestic finance.

(v) Romania is pioneering the farming of biotech crops, in particular soybeans, and the increase of the area under organic farming from 18,690 to 43,000 ha (the objective is to reach 140,000 ha) shows the development potential.

(vi) The last few years, 2002-2004, have registered an increase in livestock production and its share in overall agricultural production, but farm production is rather directed at home consumption and primary processing and retailing.

(vii) A positive trend in milk production has been registered in the last few years.

(viii) Romania's rural areas offer various ecotourism opportunities.

(ix) The existing large mountain areas are important providers of services at national level (water resources, biodiversity, recreation facilities).

3.30 On the other hand, agricultural sector development is faced with negative factors and challenges:

(a) Excessive fragmentation of farm plots and a polarised farm structure: co-existence of a large number of very small and economically unviable production units and a relatively small number of large commercial farms with few inter-linkages.

(b) Agricultural production has a predominantly subsistence character: according to estimations based upon data supplied by the INS from the Producer Balances, the share of self-consumption in product utilisation in the year 2001 was still high (for wheat, maize and barley it ranged from 48% to 55%, while it was about 60% for milk, 70% for pork meat and eggs, and over 80% for poultry meat).

(c) Few modern agricultural inputs, equipment and services are used, mainly due to a lack of financial resources. For instance, while the tractor and combine fleet has increased, a large share of the existing machinery is old and technically obsolete. In 2001, the existing machinery for cereal cultivation represented only half of the equipment needed. Low operational efficiency and the high cost of tractors are the result of frequent repairs and a high consumption of fuel and lubricants.

(d) Agricultural exports are dominated by raw materials and products with a low degree of processing (added value): live animals, cereals (highly variable annual amounts), oil crops, wine, summer vegetables, wild mushrooms, truffles and fruit nuts.

(e) Low labour productivity: €2,200 per employed person in 2001 which is only 6% of the corresponding value in the EU in the same reference year. The agricultural output value per ha amounted to €248 in 2002 as compared with €2,000 in the EU in 2001. Comparison of the average Romanian crop yields in the period 2000-2002 with the EU-15 figures (2001) reveal a 60-70% gap, except for durum wheat (+15%) and sunflower (+40%). Average milk yields in Romania are about 3,000 litres per cow as compared to the EU-15 average of 5,800 litres.

3.31 Agricultural inputs (fertilisers, seeds or planting material), equipment and irrigation and better-bred animals and buildings are only some of the investments that are much needed in the agricultural production sector. Although estimations of the total agricultural investment demand are hard to make, it is obvious that the potential demand greatly exceeds the current financing supply. The bank branch network in rural areas, however, is little developed and current bank procedures and bank lending conditions are not adapted to the specific conditions of potential farmer borrowers. In particular, most smaller farmers do not have conventional bank collateral and, at present, it is difficult for them to comply with the lending eligibility criteria of banks. Banks, meanwhile, consider agriculture a risky business and they require insurance coverage which is not widespread.

3.32 Despite this, a strong integration process is taking place in the food industry, whereby large private farming business groups invest in food processing facilities, while food and beverage companies invest in agricultural production and develop linkages with farmers to increase the quantity and quality of the raw materials that they need. While contract farming financing arrangements and commercial supplier credit from input and equipment dealers are increasing, it is not expected that they can substitute for bank lending, in particular, not for farm investments.

3.33 Potentially profitable crops and products for bank lending could be:

- Export crops cultivated on irrigated land such as alfalfa and soybean.
- Production of high value products that have an identified international market niche demand such as in the case of honey, wild fruits, summer vegetables, and spicy herbs.
- Production of biotech crops that meet international organic certification standards.
- Production of processed meat such as sausages from locally produced animals.
- Limited land-based and labour- and capital-intensive greenhouse production, utilisation of thermal waters and sterile soils, production of potting soils, flower production, and fish farming.

3.2.2 Agro-Processing

3.34 The food & beverage sector is a core industry in Romania, second only to oil processing. It accounts for 8% of the total gross value added in the economy and employs 170,000 people. The demand for food is rising each year (expected to reach some US$26 billion in 2004) and while the food processing industry is making impressive gains, agricultural production is not keeping up and a large amount of food has to be imported in order to satisfy local demand. The following aspects highlight the specific features of the Romanian food processing market:

– Food expenses account for no less than 57% of the average overall household budget in Romania versus 44% in Bulgaria and less than 30% in other Eastern European countries which have already joined the EU.

- Food consumption is dominated by basic products: no less than 22% of the food budget is spent on bakery products. Last year's average meat consumption was only 52 kilograms per capita as compared to 69 kilograms in Bulgaria and, for instance, 90 kilograms in Hungary. The consumption of vegetables by Romanians is higher with 162 kilograms per capita and potatoes, beans and cabbage constitute the largest share.

- Until the end of March, 2002, the grades and standards, which existed were neither respected nor controlled. With the new order of the Ministry of Agriculture, Food and Forestry, processors will have to observe grades and norms. Most of the standards used in the vegetable and fruit sector are not yet harmonised with those of the EU.

- Food prices fluctuate according to the supply situation. Due to an almost complete lack of market information and the use of many marketing channels, price information is often erratic and definitely not transparent. Poor grades and standards are another reason for the lack of transparency in the price formation process. Seasonal price fluctuations are very marked due to the lack of sufficient storage facilities.

- Most processing factories were built to serve both domestic and export markets. Used equipment is of Romanian origin and often more than 20 years old. In order to comply with EU and international quality and packaging standards, the food industry urgently needs investment in the restructuring of facilities, in up-to-date technologies and in new equipment for sterilising, control and packaging. Development of integrated food chains of agricultural production, storage and processing is only in the early stages, but will lead to higher quality food products.

- Due to a low scale of operations and a poor state of technology, national processors are not able to compete with international brands.

- In 1997, the changes to the price and support policies in agriculture affected the milk and dairy industry, in particular. After the full liberalisation of all milk prices and the removal of bonuses, a sharp increase in prices occurred in the first two months (by about 2.5 times), in the next month prices stabilised, and only by the end of the year did prices increase again, but this time in line with those of other food products.

- Millers and bakers buy wheat directly from agricultural producers, but only for 2-3 months after harvest. After this period, wheat is bought from wholesalers, associations or producers who store only small quantities of wheat. Some larger grain processors even prefer to import wheat and corn, as the supply and expenses related with buying from domestic sources are not reliable and too high or the quality of the Romanian grains does not meet the demand requirements.

- Most animals are raised in stables that have long exceeded their useful life, affecting productivity and causing losses due to poor sanitary and veterinary conditions. High price fluctuations and poor domestic animal quality direct meat processors to imports.

- The unfair competition of small (illegal) slaughter units, together with a low number of animals raised in the country, triggers an under-utilisation of the installed production capacities of larger-sized slaughterhouses and makes it difficult for them to invest in upgrading their facilities required to comply with the EU norms and to stay in business.

- A poor quality of existing genetic animal materials produced in the country which is mainly meant for small farmers.

- Domestic animal fodder suppliers, due to a lack of a good control system and correspondent legislation, often deliver animal feed of uncertain quality.

3.2.3 Non-Farm Rural Economic Activities

3.35 *Textile and apparel*: Textile in Romania is a US$2.76 billion dollar industry which grew by 30% from 2001 to 2002 and is expected to have an annual growth rate of 9-10% until 2010, significantly higher than the estimated 5.6% growth rate of the total economy. An average annual increase of US$120 million in the value of exports from the textile industry is expected until 2010.

3.36 SMEs constitute approximately 70% of the total number of textile companies and the majority is engaged in the production of garments. There is a growing trend for existing larger companies to split up their operations into smaller and more flexible units so as to be able to adapt to rapidly changing tastes in the fashion industry. SMEs specialise in only one or two parts of the production process, while they outsource the rest. Increasing differentiation at Western European clothing shop and store level requires many small-to-medium sized manufacturers who are sub-contracted exclusively by stores and produce clothing under strict codes of secrecy. The SMEs provide the agility, quick delivery and security that specialty stores are now demanding. Smaller companies, with a multi-skilled workforce and up-to-date computer assisted design and computer assisted CAD/CAM manufacturing facilities, including Internet connections to main consumer markets in the world, should be given priority in bank lending for investments.

3.37 *Wood and furniture*: Romania has a long tradition in wood products and furniture manufacturing and before 1990 was a major exporter of furniture. The sector accounts for an increasing percentage of the total exports of Romania. In 2002, furniture production amounted to US$731 million, of which US$474.2 million were exports (5.6% of the total Romanian exports), generating a net contribution of US$415.5 million to the national trade balance.

3.38 The exports of furniture from Romania have a good competitive potential, witnessed by the significant growth following re-entry into markets like the USA and the Former Soviet Union (FSU). These markets have an estimated demand potential of US$250 million and US$150 million respectively for furniture imported from Romania, of which volume little is currently covered. Increases in furniture production from US$614 million in 2002 to US$1,120 billion in

2010 (as planned) will trigger off corresponding growth in all areas of the sector with positive direct impact on the employment of the rural population. Exports of wood products other than furniture, mostly timber, represent only 30-35% of the production; the rest is absorbed by the domestic market for use in other products, furniture, construction, etc. The volume of exports of these products increased from US$554.7 million in 2001 to US$625.4 million in 2002.

3.39 Notwithstanding the general challenges that the SME sector in Romania faces, small- and medium-sized companies in the wood and furniture industry have significant competitive advantages based on large forests and low labour costs as compared to other countries in the region. Outside Bucharest, where most of the wood and furniture activities are located, unemployment rates are high and enterprises have in general no problems in attracting cheap labour from rural villages. The number of people employed by the wood cutting and processing industry is expected to grow to 75,000 in 2004 and will continue to grow in the next two years due to an expected increase in work and the instalment of new production capacities. Access to bank financing, already difficult and expensive, is especially difficult for SMEs engaged in wood harvesting and cutting, as they use mostly old equipment and technologies and have no valuable fixed assets which they can offer as collateral.

3.40 *Glass and ceramics*: In Romania, the annual sales of the glass industry amount to more than US$190 million, while for ceramics they are about US$116 million. Glass and ceramics exports account for about 1.5% of the Romanian total export value with about US$60 million glass tableware exports (mostly hand made) and approximately US$45 million exports of porcelain/ceramics tableware and decorative products. For glass production, Romania disposes of local supplies of sand and soda ash.

3.41 Currently, only 15% of the glass and ceramics products are made by small- or medium- sized enterprises, but their number is growing as former state-owned factories tend to be privatised and downsized. Many SMEs are exporting directly and, while they face numerous challenges, they seem to be able to manage key business issues such as price negotiations, freight options, packaging, and payment options. The tableware glass sector in Romania experienced three consecutive years of negative growth from 1999 to 2001, but in 2002 exports did grow again and surpassed the 1998-sales levels. Growth in exports of float glass indicates that there are good external markets for production expansion.

3.42 Based on sales and employment estimates, the annual productivity per worker in the glass and ceramics industry is approximately US$8,310 which compares favourably with Romania's average industrial productivity of an estimated US$5,296. For textiles the average productivity is US$6,000, for wood products US$7,029, and for tourism US$5,172.

3.43 *Tourism*: According to the INS, the number of tourists coming to Romania was 4,793,700 in 2002; approximately 2.9% lower than in 2001. The tourism industry in Romania is a US$600 million-dollar industry expected to grow by 4.3 percent p.a. over the next 5 years. Romania offers a wide range of tourism products ranging from rural tourism and cultural visits to key historical sites to beach vacations at the Black Sea.

3.44 Development of *rural tourism* has benefited from certain incentives that were offered in the context of the “Law on Rural Tourism” that was passed in 1998. The incentives consisted of a tax holiday on profits derived from the running of tourist boarding houses. In rural and eco-tourism, almost all the companies are SMEs which started with small amounts of own capital and the business is family-owned and -operated. Families who run bed and breakfast facilities have additional sources of income.

3.45 One of the main factors that impede the development of rural tourism is the poor transport infrastructure of roads, rail and air. Other problems are a lack of previous tourism experience of the operators and low business management skills. High collateral requirements of banks are the main constraint for obtaining bank loans in order to finance the refurbishment of accommodation and/or to make other required investments.

3.2.4 Strengths and Weaknesses of Non-Farm Rural SMEs

3.46 According to assessments of industry experts, non-farm rural SMEs share, irrespective of their field of activity, several positive features:

(a) Potential for economic growth and further expansion of exports: many SMEs are already exporting and there are few barriers to exporting.

(b) Sufficient supplies of required raw materials (timber; natural fibres; sand and ash) are available from domestic sources.

(c) Ample and relatively cheap labour supply.

(d) Familiarity with the need for high quality products in some sectors.

(e) Availability of skilled labour (In the textile industry the “Lohn” system has contributed to the development of skilled labour, introduced new technologies, and made management export-orientated) and the existence of strong traditional skills e.g. in glass blowing, decorations, painted glass.

(f) The EU access will bring a number of benefits (vast EU market, foreign investors, structural financial aid), but will simply costs (the need to restructure and replace old technologies and equipment with up-to-date ones; the required investment costs of the SMEs may prove difficult without adequate external support).

3.47 Main problems and weaknesses of the rural non-farm SMEs are:

- Inadequate manufacturing facilities (under-utilisation of installed capacity, obsolete equipment, lack of proper packaging equipment and packing, wasted energy problems).

- Limited marketing and sales capacity (lack of customer knowledge, ignorance of required quality standards for target markets, inadequate packaging for shipping), and low business management skills.

- Transportation costs to overseas markets, expensive working capital loans from banks, limited services from business support organisations.

3.2.5 Business Support Organisations (BSOs)

3.48 There are two categories of business support organisations in Romania: professional business associations and employers' associations. Over the past three years, BSOs in all economic sectors have grown both in number and importance. These organisations are well regarded by the government, as they facilitate the dialogue and partnerships between the public and the private sector. They also attract international support in the form of business development projects for specific sectors.

3.49 Business support services are available from local chambers of commerce; international business or economic development programmes funded by different donors; and business associations and private business consultation companies. The range and effectiveness of these services are still rather limited. A recent survey revealed that over 85% of all enterprises are members of at least one chamber of commerce or a business association/employer organisation. Members demand multiple services like: information about technologies and markets (58.9%); networking contacts (40.6%); professional services (17.4%); support in accessing bank finance (14.2%); representation of common interests with public authorities (13.5%); and training services (only 5%).

3.3 Credit Demand Constraints of Rural SMEs

3.3.1 Survey of the National Agency for SMEs and Cooperatives

3.50 A recent survey[1] of a representative sample of SMEs in Romania has identified the following main financing constraints as reported by the interviewed SMEs:

- Cash flow problems are encountered by 44% of the enterprises in the agricultural sector and by 40% of the micro-enterprises. Of the small- and medium-sized enterprises, 36% report occasional cash flow problems, while 8% of the medium-sized enterprises report continuous cash flow problems. The larger the enterprise, the greater appears the probability that the enterprise faces liquidity needs.

- The preferred strategy to counter liquidity needs, followed by most of the SMEs (40.6%), is to delay payments to suppliers. Less preferred options are delays in paying salaries and social contributions to workers.

- Leasing is declared as a preferred mechanism to acquire equipment, vehicles and hardware by 34% of SMEs; in the event of important investments, half of the SMEs would choose leasing instead of cash payment.

- Declared investment plans (Distribution in %):

1 "Situation and needs – SMEs' opinions" - survey organised by the National Agency for SMEs and Co-operatives, published in October 2004. Out of the total 1,200 questionnaires, 993 were validated. Enterprises were selected based on their size and 7 other specific sector criteria.

	Small investments	**Large investments**	**None**
Agriculture and fishery	64	2	34
Industry and energy	54	20	26
Constructions	69	6	25
Commerce	52	20	28
Hotels and restaurants	67	0	33
Transport and communications	73	3	24
Other services	52	15	33
Micro-enterprises	55	15	30
Small enterprises	57	25	18
Medium-sized enterprises	55	31	14
Total	55	16	29

– The highest small investments are planned for transport and communications (73%), construction (69%), hotels and restaurants (67%), and agriculture and fishery (64%).

– Planned large investments (highest for medium-sized enterprises) will create up to 10 new jobs (75% of the cases), up to 34 new jobs (10%) and more than 100 new jobs (8%).

– The main source of finance for investments remains own capital (87.5% in the case of large investments and 77.4% for small investments), bank loans are less important, while a third source is government development programmes.

– In terms of a combination of financing sources, for larger investments, entrepreneurs would combine own finance with bank loans and funding from capital markets. SMEs have a limited capacity to finance investments on the capital market (through the emission of bonds or the issue of stock options).

– Enterprises in agriculture and fishery (87.8%) declare that they envisage realizing investments with own funds; only 5.4% plan to also use bank loans, while 4.5% expect that to have access to government financing programmes.

– Medium-sized enterprises (30.4%) plan to use a combination of own funds and bank loans, while 47.6% expect to use only their own financing; 7.2% of the medium-sized enterprises and 11% of the small enterprises say that they will invest solely on the basis of bank loans.

– Determinant factors in selecting the source of finance for large investments are: simple and rapid procedures (52%); low interest rate (55%); low collateral requirements (32%); prestige (16%); and maintaining their independence (8%). For all the types of investments, SMEs will select the source of finance on the basis of a low level of interest rate (51.1%); simple and rapid procedures (39.8%) and low collateral requirements (22.2%).

– Collateral is perceived as a serious barrier and credit guarantee funds could play a larger role in supporting SMEs in increasing their access to bank credit.

– Main financing products are the traditional ones: about 95% of the enterprises have opened a current account in a bank; 32.7% of medium-sized enterprises and 21% of the small enterprises have bank deposits; 19% medium and 1.4% small enterprises use credit cards; 24.5% of the medium and 18.2% of the small enterprises receive commercial loans from their suppliers, and 9.3% of the medium and 7.1% of the small enterprises have investment loans.

– Only 11% of the SMEs said that they plan to prepare an investment project proposal and intend to apply for non-reimbursable grant funds such as SAPARD.

– One type of investment that the Government may want to stimulate through fiscal policies is the acquisition of modern technologies (71.9%).

– SMEs see the Government as having an important role to play through specialised financial institutions. However, this perception is strongly influenced by the former central planning role of the Government; for instance, 51.8% say the Government should become involved in subsidising lending interest rates; 21 % mention that the Government should play a role in training and advisory services; 18.8% see the Government as playing a role in facilitating business contracts; 17.2% want the Government to guarantee their bank loans, and about 11% look to the Government for the provision of good market information.

– Improvements in the overall business environment: 60% of the SMEs insist on easier access to financing and 44.4% ask for specific government development; enterprises in agriculture and fishery say that they need more special government support programmes (63,5%); 45% want easier access to financing; and 36% would like to receive better training for their workforce.

– For 42.4% of the SMEs, regulatory changes are required in order to increase investment and to expand economic activities*:* discipline in complying with existing norms and rigorous enforcement of contracts are clear priorities.

– For 34.8%, improvements in the labor legislation are second in the hierarchy.

– 29.6% of the interviewed enterprises mention the need for reduced red tape and simpler procedures for enterprise licensing and authorisation.

3.51 It may be concluded that in order to support SMEs in their development it is important to resolve both external problems (related to the overall business environment) and internal problems (which depend on the way in which SMEs are organised and perform their activities).

3.52 A non-exhaustive list of **external problems** of SMEs includes:

(a) High interest rates and commission charged on bank loans, making these funds prohibitive for both the financing of current operations and planned investments.

(b) Discriminatory treatment of SMEs, micro-enterprises and individual entrepreneurs by banks as compared to larger private or state-owned companies.

(c) Narrow range of bank products that are offered as compared with the specific features and needs of rural SMEs.

(d) High level of taxes and social contributions that need to be paid by SMEs which arrive at an accumulative figure of 60-70% of the total turnover (Value Added Tax: 18%; salary related taxes and contributions: up to 35-50%; tax on profits: 25%; other taxes).

(e) Discontinuity in the fiscal regime and regulations, affecting the capacity of SMEs to adopt long-term business and financial plans.

(f) Scarce access to appropriate, up-to-date technologies, as most of the SMEs have developed their production process on the structure of former state-owned enterprises and have inherited old, technologically poor equipment.

3.53 While **internal problems** of SMEs include:

– Poor internal organisation and operational performance of the enterprise due to initial low managerial skills and a lack of knowledge of modern business management, marketing, finance and accounting principles.

– Reliance on limited own financial resources and lack of access to external funds have condemned many SMEs to low operational efficiency and a limited scale of operations, thus affecting their further development.

– Poor access to useful market information, resulting in a limited knowledge about alternative potential markets, customers, clients and the overall business environment.

3.54 Strong points in the **demand for credit** by rural SMEs are:

(i) A high unmet investment demand by commercial farmers for inputs, equipment and irrigation facilities; in the agro-processing industry there is an urgent need for large-scale investments in plant restructuring and new equipment in order to be able to comply with the sanitary and product quality standards of the EU accession, in particular, for slaughterhouses and meat processing plants, dairies, greenhouses, vegetable and fruit processing units, and certified organic production. Non-farm rural economic activities (wood and furniture, textile and garment, ceramics and glass, and rural tourism) also need investment funds in order to maintain their competitiveness and to enter into new export markets. A rough estimation of the above total investment needs is some US$7.5 billion.

(ii) A good credit culture of loan repayments among Romanian entrepreneurs, in particular in the rural areas.

(iii) New Government strategies towards the development of SMEs and the agricultural and rural sectors, including the food and agro-processing industry.

(iv) The expanding operations of the Rural Credit Guarantee Fund which works in close collaboration with banks.

(v) Increased awareness and confidence of SMEs that have benefited from SME financing schemes in applying for new bank loans.

(vi) Increased interest and motivation of banks to diversify the bank products that they target to rural SMEs.

(vii) Graduation of successful rural micro-entrepreneurs who have received small business loans from micro finance institutions towards banks for larger loan needs.

(viii) Interest of micro finance institutions in developing collaboration agreements with banks for providing loans to SMEs in rural areas.

3.3.2 SME Demand for Bank Loans: SWOT Analysis

3.55 Major factors which **constrain** the rural SME demand for bank loans include:

- Constraints identified by potential borrowers in their <u>relationship with banks</u>:
  - ✓ Applying for a loan takes too much time and involves much red tape.
  - ✓ Lack of confidence that a loan application will be approved.
  - ✓ Too short loan maturity.
  - ✓ High interest rate.
  - ✓ Lack of a grace period.
  - ✓ Banks are perceived as discriminating against small firms, conservative and not pro-active.
- Cultural constraints on the part of potential borrowers: reluctance to incur debts.
- Business constraints:
  - ✓ Insufficient profitability of the business to repay the loan principal plus interest.
  - ✓ Cannot comply with collateral requirements of banks.
  - ✓ The inability to receive more than one bank loan at the same time, e.g. investment and working capital loans together.
  - ✓ The requirements for the SME applicant to have a positive net worth, to be registered, and to have paid all its taxes.

  - ✓ Lack of business management skills.

- Other constrains:

  - ✓ Poor marketing of bank products.
  - ✓ Lack of adequate business support services.
  - ✓ Lack of a rural bank branch network.

3.56 **Opportunities** for increased loan demand by rural SMEs include:

– Increased demand for investment loans in view of the EU accession (compliance with product quality, sanitary and environmental standards).

– Coordination between different donor financing programmes for SMEs: A special UNDP-coordinated Donor Task Force would avoid duplication and allow better targeting.

– Over the next two year period, the Government has targeted the development of business advisory services with funds to be provided by the new PHARE programme.

– Extension of micro credit operations under the new Law on micro finance institutions (currently under consideration and expected to be approved by the Parliament before the end of 2004).

– Amendments to the Leasing Law expected for next year.

– Investment demand in order counter increasing competition on internal and external markets.

– Investments in agriculture production and the scheduled privatisation of state-owned agriculture companies will stimulate the further development of private SMEs in rural areas.

– A more stable and favourable overall economic and business environment will encourage increased investments by SMEs.

– A new Government initiative for establishing a special capital facility.

3.57 Main threats are:

- The scheduled 2007 EU accession date may trigger off a faster death rate of SMEs, in the event that they do not succeed in complying with the EU norms.

- Lack of bank procedures and bank products that are adapted to the specific features and financing needs of rural SMEs.

- Extension of grant finance schemes may undermine the entrepreneurial culture and loan repayment discipline of rural SMEs.

- Lack of own capital from retained business profits for needed investments.

3.4 SME Profiles and FAO Survey of SMEs in Rural Areas

3.4.1 General Features

3.58 The FAO team gained some first-hand knowledge of investment and financing issues of SMEs in rural areas by interviewing a number of rural entrepreneurs and farmers during the country missions. Particular attention was given to the different sources for financing, the perceptions of these sources and the potential credit demand for future investments. SMEs were visited in the relatively well-developed Timis County in the western region where the city of Timisoara is located (the 4th largest city in Romania, with some 700,000 inhabitants) and the poorer Calarasi County in the south-eastern region (Calarasi town has approximate 70,000 inhabitants).

3.59 *Annex 4* shows the profiles of the visited SMEs. Due to a lack of formal financial statements and scarce details received from the interviewees on the profitability of their enterprises, only cash flows could be produced. Positive cash flow values show the typical SME feature of low labour costs and other expenses of enterprises that have already passed the difficult start-up phase.

3.60 Moreover, the FAO national consultant carried out a survey among SMEs in rural communities, using a random sample of 102 clients from banks and credit cooperatives. The specific purpose of the survey was to get a better insight into the perceptions of clients on bank credit. Out of a total of 102 interviews, 93 questionnaires were validated in three regions: the western part of the country (Transylvania – the most developed region), the southern part (Muntenia – a poorer developed region) and the north-eastern part (Moldova – the least developed region). *Annex 5* shows the questionnaire and detailed results of the analysis. Main findings from both the SME profiles and the survey are:

– Most enterprises are limited liability companies, family-owned and -run (the majority have 2 partners – husband and wife). Own capital has been the main source of finance for getting started and for current operations: in general, the role of bank credit is marginal.

– Consolidated small rural enterprises usually have a fairly long business experience, but over time they have not grown much and they remain small.

– In the event of liquidity shortages, the main solution used is to delay payments to suppliers and employees.

– Business and financial management practices, in general, are not well developed: only half of the managers/owners use a business plan. Formal financial statements, apart from mandatory balance sheets, are not kept and none declared to have had its financial accounts audited.

- SME managers show little interest in financial data, or at least do not want to share them with outsiders: one third did not answer questions regarding the subscribed capital and the turnover of the enterprise.

- Subscribed capital is low and understates the strength of the enterprise. The calculated average per respondent is slightly above €20,000 – an amount that may be indicative for the minimum loan amount to be extended by banks under the Facility.

- A high proportion of the SMEs appear to be poorly informed about the requirements of banks for loan applications and about loan approval procedures, which would justify the provision of specific TA directed to the marketing of the Facility to rural SMEs.

- Financial discipline among the rural SMEs appears encouraging: all respondents declared that they have observed their loan repayment schedule with the banks.

- The determining factor for respondents in selecting the source of loan finance is the lower collateral requirement.

- Main banking products used are "current and savings/deposit accounts", while "commercial credit" from business suppliers in the form of deferred payments for delivered goods is the main source of external finance.

- Banks are perceived as conservative and not pro-active towards rural SME clients, discriminating between small entrepreneurs versus larger local companies and foreign investors.

- Existing SME financing programmes are considered to be bureaucratic and slow, and even corrupt, in the case of SAPARD.

- The range and quality of business advisory services that are currently available to rural SMEs appear limited and need to be further developed. An example could be the low amount of resources that is spent by the Calarasi Chamber of Commerce on providing advice on business legal procedures and business plans. Similarly, the provision of donor-funded business advisory and lending services depends on the continuity of the financial resources: if these funds dry up, the focus may shift away from rural SMEs.

3.4.2 Credit Demand Constraints

- Most entrepreneurs relied on own funds for starting their business. External resources, apart from contributions from family and friends and commercial credit from suppliers, appear to have been non-existent. Assets already in their possession (in particular, land) together with profits from other existing business and accumulated savings were used to start the new business.

- Working capital is provided not only by the family who owns and operates the enterprise but also by the employees. Delaying the payment of salaries and social securities, in the event of liquidity need, appears the easiest solution.

- SMEs in the Timis County, which were all clients of the NGO-based micro finance institution, CHF International, have not normally accessed any commercial bank loans for investment, even when they have profitable business and bank accounts.

- The main constraints[1] of bank loans as perceived by the SMEs include: excessive reliance by banks on conventional collateral and high collateral requirements (250% or higher of the evaluated replacement value of fixed assets), high interest rates and bank commissions, excessive bureaucracy (complex and lengthy loan application procedures), bank inflexibility (only one loan at any one time), and short maturity of the loan. The most significant reason for not applying for bank loans is the cumbersome loan approval process, while high interest rates come second.

- Although lease payments are high due to the shortening of leasing periods over the past few years, SMEs often find leasing more attractive than bank loans for the financing of required equipment: no collateral is required, and in the case of leasing obtained from abroad, only after 4 years does VAT need to be paid on the residual value of the leased asset.

3.4.3 Potential Demand for Financial Services by Rural SMEs

3.61 The demand for financial services by SME is varied, and normally includes loans, savings, and miscellaneous financial services. According to estimations there were about US$215 million of funds for the provision of loans to SMEs available in Romania in 2003, and some fund providers extended loans of up to €500,000 to medium-sized enterprises.

[1] The main reasons for not applying for a loan as identified by the FAO survey on SMEs in rural areas (see details in the annex) are:

- too long process and involving much red tape (100)
- too high interest rate (89)
- loan maturities shorter than envisaged (59)
- non-compliance with the collateral requirements of banks (59)
- lack of trust that a loan application will be approved (41)
- reluctance to incur debts (37)
- insufficient profitability to repay the loan plus interest (22)
- lack of knowledge on the loan application procedures (15)
- sufficiency of own income sources (15)

3.62 In addition to bank lending, there is also some grant funding available for SMEs. For instance, under the EU PHARE programme, a grant scheme has been established that is targeted at micro-enterprises and provides start-up capital to prospective entrepreneurs. The grant capital will be tied with technical assistance and the total available amount is €40 million. The National Agency of SMEs also provides grant funding to 13 targeted industries, including textiles, wood and woodwork, and metallurgy. Other funding sources, such as venture capital and leasing are also available, but they are likely to be accessible more to the upper-end of the medium-sized companies in the SME sector.

3.63 International experience suggests that a considerable proportion of the potential applicants are not creditworthy, especially if loans are extended to start-up entities. When banks were questioned about this, it appears that loan declination rates ranged from 5% to 35% of the total applications, with an average of 20%. Using this average figure as a base, approximately 80% of those willing to borrow would be creditworthy.

3.64 Not all rural SMEs, however, either want or need to borrow. A World Bank study of financial markets in rural Romania[1] estimated that only 50% of all private sector rural enterprises had a need of loans. It may be assumed that the demand for credit by SMEs in rural areas, while differing considerably, is smaller than the credit demand in urban and peri-urban areas, while the individual loan amount also tends to be smaller than loans extended in urban areas. The Transylvania region seems to average rural and urban areas more than in other regions of the country and also, with the exception of Bucharest-Ilfov, rural SME loans are projected at 22% of the total potential loan demand of SMEs.

3.65 In conclusion, by far the largest demand for term loans for investments in the forthcoming years is expected to occur in the agricultural sector and the agro-processing industry, this in view of the forthcoming EU accession. In fact, the continued existence of SMEs in these two sectors depends to a large extent on their ability to adapt to the regulations and the norms of the EU. In particular, most of the animal production and food processing SMEs will need to restructure their working facilities and to renew their equipment in order to conform to the new norms and standards on product quality and sanitary conditions.

3.5 Potential Rural SME Borrowers and Priority Regions

3.5.1 Potential Borrowers

3.66 Final borrowers under the Facility are eligible according to the definition of rural as specified by the EU and EBRD for Romania, i.e. “SMEs whose core activity is carried out in communities with less than 50,000 inhabitants”. While this definition of rural may be considered suitable for SMEs engaged in agricultural production and other typical non-farm rural economic activities, it does not seem, realistic or even desirable for the important agro-processing sector in the country. In fact, many small and medium-sized enterprises in food processing are located in larger communities, although their activities are closely linked with agricultural production, while the development of effective food chains is of crucial importance both for producers and consumers as well as for the economy as a whole. At the same time, in Romania, food processing SMEs, in particular, are subject to strict requirements related to the EU accession and they

[1] Financial Markets, Credit Constraints and Investment in Rural Romania, January 2001.

urgently need to restructure their current plant facilities and to invest in new equipment in order to comply with the new regulations and norms. In the event that they are not able to finance these investments and will not comply with the EU hygienic norms and food quality standards in 2005 and 2006, they will be forced to close down with resulting substantial losses in added value and local employment. In the view of the FAO team it is therefore necessary to include agro-processing SMEs as eligible final borrowers under the Facility and to adopt for this purpose a more flexible definition of rural areas by, for instance, extending the coverage of rural communities from less than 50,000 up to 100,000 inhabitants. In the Conclusions and Recommendations chapter, specific eligibility criteria will be proposed for agro-processing SMEs.

3.5.2 Priority Regions

3.67 In order to allow the banks full discretion in the type of rural investment and the specific rural location of the SME that they will choose to finance, in general, no priority regions or targeting of specific rural economic sectors should be set. Based on the existing branch network of participating banks in the Facility and, in the event that the use of intermediaries like MFIs is accepted, one would expect to see the actual bank credit under the Facility concentrated in certain clusters, defined as a specific geographical area or even a specific rural economic sector or industry, as described in the third chapter of this report. Such an orientation appears also to be in line with the pilot character of the Facility, according to which it would make a lot of sense for a bank to start initially in more favourable regions for rural business activities and to thus capitalise on the most economic use of a limited volume of loan resources. This approach may reduce the bank risks and increase the value added as compared to an alternative strategy geared to a more balanced territorial distribution of the bank loans. Moreover, the SAPARD programme, which this Facility as much as possible will co- and pre-finance, has a strong focus on investment projects in specific agricultural production and agro-processing activities, which have been as defined by the government as priorities in view of the EU accession.

4. CONCLUSIONS AND RECOMMENDATIONS

4.1 Main Findings on the Supply and Demand for Rural Credit

4.1 Throughout the paper, the strengths and weaknesses of rural SME financing have been highlighted. There is good and consistent evidence that economic growth in Romania has gathered pace and rural areas are not excluded from this general tendency. However, resources allocated to rural areas remain under-utilised. One of the reasons for this is the inadequacy of financial services to match the needs of local business, notwithstanding the number of specially designed financing programmes.

4.2 At this juncture, current resources to finance SMEs, earmarked for rural areas, vary within wide limits. There are non-reimbursable grant funds, such as SAPARD and, to a lesser extent, PHARE, but also government-financed grant programmes; access to such funds is typically subject to lengthy and, at times, prohibitively cumbersome procedures. Some potential investors go to great lengths to become eligible for non-reimbursable funds, but such efforts often lead to delays and make the timely capturing of investment opportunities impossible. There are more and more credit programmes, with sources provided either by international financial institutions or directly by Romanian banks' foreign parent institutions, which are subject to standard bank practices and are granted at market conditions. Access to these credit programmes, however, is often rather cumbersome and can be quite costly. The demand for such bank credit is, therefore, not very high, unless it comes as co- or pre-finance with grant investment funds. Lastly, there are the micro-credit programmes of MFIs or credit cooperatives, which typically provide lower loan amounts and at higher cost than bank credit, but which are more readily available to clients who have little access to other financing schemes.

4.3 Information is critical to ensure the adequate use of existing financing programmes or facilities. While rural SMEs make efforts to obtain better information, they are not well positioned to take advantage of such information. Thus, government institutions, donors, NGOs, and banks issue various documents – public reports, booklets, posters – to get the general public acquainted with the programmes and with the conditions required for applying for the facilities. Such information is also available on the Internet with a multitude of sites that provide data and links to these programmes. One such site is "www.finantare.ro" that has been developed by a number of NGOs with the support of the Information Centre of the European Commission in Romania. It provides a wide range of information regarding available grants and credit facilities as well as presenting links to other sites that give more detailed information on specific issues.

4.4 However, rural SMEs can hardly compete on an equal footing with other market participants. Printed documents seldom reach small rural communities where there are no bank branches; access to the Internet, albeit available virtually everywhere across the country, has not yet entered into the day-to-day practice of rural entrepreneurs. Consequently, word of mouth communication plays a pre-eminent role in rural communities and such a tradition can be detrimental to accurate and up-to-date information.

4.5 The proposals that are formulated below refer to the design of the Facility and are meant to improve access to financial resources by well-established rural SMEs and to generate a demonstration effect among rural entrepreneurs. In this respect, both lenders and potential borrowers need to adjust their current practices. A second group of proposals is related to the future involvement and strategy of EBRD versus the Romanian rural financial market. They are in response to the challenge of adopting a new approach to EBRD support programmes in emerging transitional economies and they often require legal adjustments or just the enforcement of an existing piece of legislation.

4.2 General Design of the New Rural Credit Facility

4.6 The Facility is meant to provide credit resources to rural SMEs. As outlined in the report, the potential demand for such resources is assumed to be high. Probably, the most obvious utilisation is to pre- and co-finance SAPARD investment projects with bank credit. However, the Facility could also have more ambitious goals and the availability of a non-reimbursable technical assistance (TA) component supports such an idea. Moreover, if carefully designed, the Facility could ensure quite rapid loan disbursements with a simultaneous positive impact on the adoption of market-orientated practices, and have a favourable demonstration effect in rural communities.

4.7 From this perspective, there are two avenues possible for the implementation of the Facility. The traditional approach is to concur with the banks on the general loan terms and conditions and to allow the participating banks to on-lend the received loan funds to potential final borrowers. The non-reimbursable TA component would, in this case, favour the lender only, thus increasing interest in the Facility on the part of the banks. The main benefit of such an approach would be that banks, in addition to loan funds, can dispose of TA support. Hence, the number of bank credit officers who learn how to deal with investment loans for SMEs in the rural areas can increase. Over a longer period of time, such a development could be valuable, assuming that credit officers make proper use of their newly-gained knowledge. However, such an approach encompasses the risk of rather slow loan disbursements, since it does not really tackle the main constraints that currently limit the access of rural SMEs to bank credit. For instance, it has taken the World Bank Rural Credit Facility twelve months to disburse just US$11 million and three more years may be needed to exhaust the total rural credit and leasing facility of US$58 million as part of the total WB loan of US$80 million for the project.

4.8 The very existence of the TA component in the EBRD/EU Facility provides a unique opportunity to adopt a second avenue in which part of the non-reimbursable TA component of the Facility will be used for making bank loans more attractive to rural SME borrowers. The proposals that follow under this avenue remain fully in line with the EBRD principle that bank credit should be on-lent to final borrowers at market terms. In order to put SMEs on an equal footing with other borrowers and to make them more interested in accessing the Facility, it is proposed to cover some costs that loan applicants incur prior to loan approval and disbursement from the TA grant component of the Facility. One of the important benefits of such an approach is that it would make the credit facility more attractive to final borrowers and could significantly speed up its disbursement. The marketing of the Facility would be structured in such a way that it better highlights the benefits to the final borrower. If this approach is accepted, several measures should be taken in order to establish the missing links in the crucial bank/client relationship. These measures are discussed below.

4 .3 Establishing the Missing Links in the Relationship between Banks and Rural SMEs

4.3.1 TA Services to be Provided by MFIs

4.9 As outlined in this report, banks and other financial institutions often express their readiness to grant loans to SMEs, while SMEs are interested in receiving loans for investments that they intend to make and that they consider bankable. For various reasons though, banks and potential borrowers often do not manage to find common ground in this respect. A possible solution would be to use the services of a third party or an agent who intervenes between a bank and a SME and facilitates the access to bank loans. First of all, such an intermediary should act as a market information agent and provide clear and concise information on the credit facility to potential borrowers; direct acquaintance with the agent's representative could reduce the lack of confidence that the rural entrepreneur has in the real possibility of obtaining a bank loan. Second, the agent could support the SME in drawing up a business plan and preparing all documentation that is required by the bank to apply for the loan and subsequently to appraise the loan request. Third, the agent could also support the SME in managing and maintaining its cash flow as scheduled and thus help it to overcome liquidity problems. And finally, if agreed with the bank, the agent could also periodically follow up on the outstanding loans and draft monitoring reports for the bank.

4.10 All the above could be conducted by a micro finance institution (MFI) with whom the SME has already worked. For a small fee, which could be covered by the non-reimbursable TA component of the Facility, the selected MFIs would exert this support role as part of their overall work with rural communities. The idea was discussed with the country director of CHF International, Mr. William Seas, who expressed the interest of his organisation in taking part in this activity. He underlined that CHF and other successful MFIs have accumulated a good knowledge of the Romanian rural sector and SMEs and that they would certainly be able to identify good bank clients and to distinguish promising SMEs from less promising ones. In fact, there are numerous micro- and small-enterprise borrowers who could "graduate" from the MFI financial support and who would need more substantial loan amounts than are available from MFIs. This "graduation" process would take place more smoothly, if the SME could obtain its first bank loan through the intermediation of a MFI with whom the enterprise has already been acquainted for a long period.

4.11 Such a technical assistance approach would speed up the disbursement of loan funds under the Facility, improve relations between banks and rural SMEs, and have a demonstration effect on other rural SMEs. The traditional word of mouth knowledge and communication which are used in rural areas could thus be turned into a useful instrument for establishing better relationships between banks and clients.

4.12 Some of the above functions could also be provided by other organisations such as professional and territorial business associations or private TA providers. Banks themselves could identify potential agents to whom they would like to charge such functions. The intermediation fee should not be disproportionately high: an indicative level could be 2 percent of the loan amount, payable only if and when the loan is approved and disbursed. For loan amounts above €100,000 the fee percentage should be lower. Preliminary discussions with the country director of CHF International suggested that the recommended fee level would be reasonable and a more detailed proposal could be prepared, if the EBRD/EU is in agreement.

4.3.2 Ways of Interesting Rural SMEs in Accessing the Facility

4.13 Firstly, the business plan, the projected cash flow, financial statements, and all other documentation that is required by a bank for the appraisal of a loan application could be prepared by the potential borrower with TA provided by a third party (an MFI or other organisation), as suggested above. The main merit of this approach is that it eventually creates a direct relationship between banks and rural SME clients and thus addresses one of the existing major constraints in rural finance. According to this line of thinking, a SME could benefit from this opportunity only once. Should it want to apply for a new loan under the Facility in subsequent years, it will need to comply with the bank's loan application requirements on the strength of its own resources.

4.14 Secondly, bank loan collateral requirements are currently especially burdensome for rural SMEs. There are two main options for a SME. The bank either accepts mortgage on rural real estate and/or pledges on moveable assets of the enterprise at a sufficiently high market value or it obtains for a fee (which is passed on to the borrower) a credit guarantee from a specialised institution. In either case the overall transaction costs can be rather high – amounting to 2-3 percent of the requested loan amount – and it goes without saying that the lower the loan value, the higher the relative transaction costs. In order to reduce these costs, the SME could be reimbursed for a part of the total cost that it pays for such a purpose. In principle, SMEs should be eligible for this support under tight conditions (for instance, support of no more than, say, 1.5 percent of the approved loan amount, and for investment loans alone, and only if the SME does not benefit from other grants such as SAPARD).

4.15 Thirdly, agricultural projects are often required to get insurance coverage for specific risks. Such insurance typically carries a rather high premium, since agriculture is subject to higher risks than other industries. At times, these premiums are perceived by SMEs as prohibitively high and may deter them from carrying out profitable investment projects however well they may otherwise be founded. It is also true that the practice of reducing risk through the payment of insurance coverage does not belong to the traditions of rural people. Covering part of the insurance premium during the first year, using for this purpose a small fraction of the TA component of the Facility, would support the execution of viable agricultural investment projects as well as stimulating a new attitude towards the adoption of insurance policies and instilling a more market-orientated approach among entrepreneurs in smaller rural communities.

4.4 Proposed Features of Loan Agreements between EBRD and Banks

4.4.1 General Remarks

4.16 The overall envelope of the Facility consists of €50 million loan funds and a €10 million non-reimbursable TA grant. Since the envelope is meant both for Romania and Bulgaria, it is assumed, notwithstanding the general principle of first-come-first-served, that Romanian financial institutions will be allotted some 60 percent of the above-mentioned total amounts.

4.17 On the basis of the interviews by the FAO team, some six banks and one leasing company have shown interest and may be eligible for the Facility pending their current exposure to EBRD. Individual loan agreements may vary between €3 to 10 million for each bank and up to €1 million per leasing company. The loan maturity could be 10 years with an 18-month grace period for banks and up to 7 years and a 12-month grace period for leasing companies. Specific conditions (interest rate, fees, and commissions) in the loan agreement contracts with banks would be based on the normal practices of EBRD, but they should take into account the competitive rates, in particular those practised under a similar rural credit and leasing facility by the World Bank Rural Finance Project. Conditions significantly less favourable might prevent banks from taking part in the Facility. Leasing companies are subject to less favourable conditions consistent with the view held by the EBRD of a higher financial risk of such loans. According to the FAO team, the idea of also extending loans under the Facility to leasing companies in the present circumstances mainly serves as a pilot test case rather than being intended as a genuine on-lending channel of EBRD loan funds to rural SMEs.

4.18 The design of the Facility clearly depends on the time span within which the EBRD intends to have disbursed the full credit facility. With few or no specific measures taken to speed up the process, the total amount would likely be disbursed in 18 to 24 months. Taking into account the relatively small total credit amount, there is the risk that the Facility will be launched but will remain rather unnoticed with little or no impact on the improved functioning of the rural financial market in Romania.

4.19 Fortunately, however, the Facility benefits from a substantial TA component and an effective use of these grant funds can make the difference, significantly increasing the impact that the Facility might have on investment lending and business development in rural areas. The FAO team recommends that the goal pursued by the new EBRD/EU Facility be precisely to launch a bank lending programme for small- and medium-sized enterprises that will have the strongest possible impact and a high demonstration effect on other actors. It can also be expected that the new Facility would be followed up by other credit schemes on a wider scale that will support the better utilisation of investment opportunities and thus promote competitive business development in rural areas. The recommendations that follow are geared towards such an ambitious goal.

4.4.2 Proposed Timetable of the Facility

4.20 *November/Mid-December 2004*: to interested banks and, possibly, leasing companies, the EBRD launches its preliminary offer of a credit facility targeted at rural SMEs, indicating minimum and maximum credit line amounts per bank and financial conditions (interest rate, maturity, grace period, commissions, and other regular features in a standard EBRD loan agreement). The offer should also broadly describe the types of potential final borrowers and the main purposes and loan size range that might be considered for the on-lent amounts. Moreover, it should specify the possible uses of the non-reimbursable TA component from which both banks and final borrowers would benefit, and outline the main features of the bidding process for TA service providers, details of which, however, should remain open at that stage.

4.21 *Mid-January to End-February 2005*: Specific credit negotiations with the banks and leasing companies qualifying for the Facility.

4.22 *End-February 2005*: Contracts with banks are concluded. TA programmes tailored for each participating bank and starting of the bidding process for TA service providers.

4.23 *March 2005*: Preparation of the overall publicity campaign and the marketing programmes of participating banks for the launching of the Facility.

4.24 *End-February 2006*: The whole sum of the loans has been fully disbursed and on-lent to final borrowers; banks will continue to on-lend amounts under the Facility based on repayments from the existing loans.

4.4.3 Specific Conditions of the Facility

Final borrowers

4.25 The FAO team is of the opinion that as few restrictions as possible should be attached to the loan agreements between the EBRD and the banks. The latter should have full discretion for accepting or rejecting loan applications, provided that the final borrowers are eligible according to the definition of rural as specified by the Facility, i.e., "SMEs whose core activity is carried out in communities with less than 50,000 inhabitants". While this definition of rural may be considered feasible for SMEs engaged in agricultural production and other typical non-farm rural economic activities, it does not seem, however, realistic or even desirable for SMEs in the important food- and agro-processing sector in Romania. In this sector the majority of the small- and medium-sized enterprises are often located in larger communities. Moreover, they urgently need to carry out major restructuring of their plants and to invest in new equipment in order to comply with the norms and regulations of the EU accession. In the event that they are not able to finance these investments and do not comply with the new norms in 2005 and 2006, they will be forced to close down with the effect of substantial losses in added value and local employment to the country as a whole. It may also be remarked that a number of these SMEs, as part of their efforts to develop a competitive integrated food chain, have close links with market-orientated farmers as suppliers of raw materials to whom they provide important support services such as agricultural inputs and TA. The FAO team therefore recommends the EU/EBRD to adopt greater flexibility in the eligibility of agro-processing SMEs under this Facility and proposes the following specific criteria:

- Allow the inclusion of communities with more than 50,000 inhabitants (as set by EBRD) but less than 100,000 inhabitants (as under the WB RFP).

- Target indicatively small enterprises and the lower end of medium-sized agro-processing enterprises with up to 100 permanent employees (as set by EBRD). Note: seasonal workers are not included in this figure.

- Target agro-processing SMEs with a total asset value of up to €5 million (as set by EBRD).

- Prioritise co-finance between SAPARD and the Facility with the provision of bank loans under the Facility up to a loan size of €250,000.

- Finance agro-processing SMEs which have established forms of vertical integration with market-orientated farmers for the regular and reliable supply of high quality raw materials and which provide to these farmers with essential support services such as inputs and TA.

Loan products

4.26 Indicatively, three quarters or more of the amount on-lent by a bank should be earmarked for investment loans, while up to one quarter could be used for financing (permanent) working capital requirements, though only in conjunction with an investment project. Financing of land and buildings (as insisted upon by the interviewed banks), as well as pre- and co-finance of investments together with other financing schemes (grants or credit) should be allowed. Typically, the size of a bank loan to a rural SME could range from between €15,000 and €250,000 and banks should have full discretion to grant loans within this range.

New and existing bank clients

4.27 The FAO team supports the view expressed by all interviewed banks that the Facility should not be restricted to only new bank clients, but that existing bank clients should also be able to benefit from the Facility. In the latter case, however, borrowers should not have received term loans before, while the intended new investments should aim at expanding or diversifying their current production activities with the generation of new permanent jobs. In general, no start-up enterprises will be financed under the Facility.

4.28 All lending terms (interest rate, commission, maturity, grace period, etc.) between the bank and the final borrower will be set at market rates according to the bank’s standard practices and discretion.

Loan collateral

4.29 The Facility aims to contribute to improving the access of rural SMEs to bank lending. Since the cost of credit will not be altered by the Facility, other conditions – and especially the collateral requirements – should be improved as compared to current practices in the banking industry. In this respect, the contract between the EBRD and each bank should explicitly state that collateral conditions for the loans extended under the Facility should be established according to best international practices and the use of different types of collateral should be further developed with TA to be provided to the participating banks.

Priority regions and rural economic activities

4.30 In order to allow the banks full discretion on the type of rural investments that will choose to finance, in general, no targeting of priority regions or specific rural economic sectors or industries should be set. However, if the use of intermediaries like MFIs is accepted, one could expect to see the actual bank credit under the Facility concentrate on certain clusters, defined as a geographical area or a specific rural economic sector or industry as described in the third chapter of this paper. Such an orientation appears to be in line with the pilot character of the Facility and it would make sense to start initially in the most favourable rural regions and to capitalise on the most economic use of a limited volume of loan resources. This approach may reduce the risks to the bank and increase the value added as compared to an alternative strategy geared to a more balanced territorial distribution of the loans. Moreover, the SAPARD programme, which this Facility as much as possible will co- and pre-finance, has a strong focus on investment projects in specific agricultural production and agro-processing activities which have been defined by the government as a priority in view of the EU accession.

4.4.4 TA to Banks

4.31 Romanian banks have a rather limited experience in dealing with SMEs, particularly those located in rural areas. While they acknowledge the need to devote more loan resources to this clientele, in practice banks keep focusing on urban clients with a strong emphasis on lending services for individuals (consumer and mortgage lending). Therefore, the Facility becomes attractive to those banks that are prepared to expand their activity to smaller rural communities, particularly thanks to the TA component.

4.32 However, conditions are very different from one bank to another, and specific TA should be designed for each participating bank. Thus, RCB has the largest loan portfolio to SMEs and it runs a good range of specially designed lending programmes using various sources of funds, including those received from EBRD. The large branch network of the bank also provides the opportunity for a more rapid disbursement of loan funds with local bank branches generally having a higher authority to approve loans, while the cost of the credit makes it quite attractive to potential borrowers. However, the bank’s procedures are not adequately adapted to SMEs, whose specific features are not being considered in the loan application requirements and procedures. The whole lending operation process of RCG is excessively cumbersome, and clients often complain about the lack of an active “partnership” with the bank. Therefore, in the case of RCB, it would be useful to define better lending practices and procedures specifically tailored to rural SMEs, and these should be incorporated in the contract with the EBRD and may qualify for TA support under the Facility.

4.33 Smaller banks, on the other hand, usually treat their customers in a more personal way, but they charge higher interest rates and/or bank commissions. Branches typically have less authority level to approve a loan and, at times, they have little experience in providing investment credit. For such banks, the focus should be placed on TA for term lending for investment projects and again this should be specifically mentioned in the loan agreement contract with the EBRD. For instance, one of the potentially participating banks (RB) openly expressed its interest in receiving, as TA, better designed lending practices and procedures for credit officers as well as support in the development of credit scoring models for the investment projects of rural SME clients.

4.34 Above and beyond that, TA for banks could also address some of the drawbacks that hamper their relations with clients. A couple of suggestions in this respect are outlined below:

(a) It has become tradition in Romania to accept as collateral buildings and real estate only. Such practice is very costly to rural borrowers (evaluation, notary, and registration fees are high and banks require a multiple of the loan value as collateral) while it is still far from reassuring to banks. One could even argue to the contrary that since the bank focuses on the collateral rather than on the client’s business plan, repayment capacity and cash flow, it may end up as a real estate manager. Clients from small rural communities, in particular, are more disadvantaged, since their collateral is very conservatively evaluated by banks. Therefore, in order to make the Facility more attractive, TA should also consist of supporting banks in defining and using other forms of collateral, according to best international practices.

(b) Banks tend to require an enormous number of documents prior to deciding on whether to grant a loan. Some of these documents are already in the client's files, others are simply irrelevant for the loan appraisal. In order to streamline the loan procedures and to adapt them to the special features of rural SME clients, TA to banks should consist of providing support to rationalise the required paper work and to focus only on important information and key issues in the loan applications that are relevant for the loan appraisal (e.g. by including adequate risk and cash flow analysis) and the loan approval decision.

4.5 Marketing of the Facility

4.35 In order to meet the ambitious disbursement schedule outlined before under 4.2, two conditions should coincide. The first is to implement the set of measures discussed in this paper in order to establish the missing links in the relationship between banks and rural SME clients. The second is to launch a publicity campaign and to develop comprehensive marketing programmes for each participating bank in order to acquaint potential final borrowers with the financing terms and TA opportunities provided by the Facility. Among the marketing activities to be carried out are the following:

- Organisation of one or more press conferences, to be held by the local EBRD office, possibly together with representatives of the European Commission.

- Calling of meetings between each participating bank and professional or territorial business associations, MFIs and other potential intermediaries.

- Preparation of posters and other written materials that highlight the main features of the Facility and lending terms as adopted by each participating bank and displayed in its bank branches.

- Participation of one or more relevant bank official in TV broadcasts and radio programmes dedicated to rural business and finance.

- Sending of letters by the headquarters of each participating bank through its branches to both existing and potential rural SME bank clients who are eligible and might apply for loans extended under the Facility. Such letters should outline the main features and terms of the bank loans as well as indicate both the advantages and the responsibilities of the clients should they decide to apply for loans.

- The posting of the main features of the Facility on relevant websites.

4.36 All costs associated with the marketing of the Facility can be covered using the TA component. The minimum required amount is estimated to be not below €100,000, while the maximum total amount may go up to €300,000.

4.6 Policy and Strategy Recommendations

4.37 Some relevant policy issues are related with an eventual enlarging of the Facility in the future, assuming that the EBRD is interested in continuing its catalytic role of stimulating the growth in less favoured rural regions. Recommendations made below have as a common feature the aim to overcome in a more systematic way the current constraints with which rural financial markets in Romania are confronted.

4.6.1 The Role of Credit Cooperatives

4.38 The FAO team is of the opinion that the expansion of bank operations in rural areas in Romania will remain quite limited for a number of years to come. Ultimately, banks' costs remain rather high as compared to the potential income that they expect to earn from small rural bank branches. The main interest of banks is obviously focused on expanding their operations in large urban towns which offer a wider and more profitable spectrum of banking business opportunities. However, over time, once the potential for further growth of urban banking services becomes less evident and in accordance with an increasing competition among banks for the same clientele groups, banks will probably start to reconsider a careful expansion into smaller cities and rural communities with some economic potential. The time frame required for such a development, however, would not be, realistically speaking, shorter than five years. Meanwhile, business opportunities in rural areas will be financed by using methods that are already put in place, including the use of specific financial resources from IFIs that are targeted for such a purpose. Even so, this approach will not resolve the main constraint of a general under-utilisation of available financial resources, since banks are not the best mechanism for accessing dispersed rural clients and their rural lending amounts will remain rather small.

4.39 A possible way to overcome this constraint is to use credit cooperatives (CC) as a means for on-lending the resources provided by IFIs. CCs are better represented in rural areas and their presence could grow significantly in the years ahead. It should be pointed out that the legal status of CCs has markedly improved recently and they are now fully in line with EU standards; thus, at least 50 credit cooperatives are required to create a network and to establish a so-called "central house". There are tight capital requirements for each CC network, which will fall under the supervision umbrella of the central bank. The overall situation of CCs is expected to evolve further. Currently, there is only one active network, while a second one is in sight. A timetable for CCs to meet new and much higher capital requirements is already foreseen and will be achieved in phases.

4.40 All in all, one may assume that by mid-2005 CCs could become a prospective reliable counterpart for IFIs and their potential should be exploited and enhanced by using IFI resources. However, such collaboration should be strictly limited to rural areas – in which CCs have a comparative advantage and banks have a less immediate interest in developing their own bank operations.

4.6.2 The Potential Role of MFIs

4.41 MFIs have been active in Romania since the mid '90s, most of them are financed from external sources. They have a good knowledge of the Romanian economy and their expertise has become particularly valuable in sectors and geographical areas that are relatively less attractive for profit-orientated capital. Over time, most of them have expanded their scope, increased their turnover, and some are near the breakeven point towards fully covering their costs. Their legal status, while improved over time does not yet fully support an eventual transformation of the best-performing MFIs from NGOs into fully-fledged, profit-orientated businesses.

4.42 A steering group which consists of international legal experts has drafted a specific piece of legislation whose enactment is expected to pave the way towards the strengthening of MFIs. The bill removes, in particular, the weaknesses of the current legislation regarding the fiscal regime of MFIs and the loan amounts that can be borrowed from MFIs and it establishes clear procedures for registering MFIs as commercial companies. At present, the bill is being reviewed by the various Romanian institutions concerned (the Ministry of Justice, the Ministry of Public Finance, the National Bank). Once the legal status of MFIs is clarified, some of them could become reliable counterparts to IFIs in market-based financial arrangements. Currently, the few MFIs that are actively involved in the implementation of various financing programmes can do so only with government guarantees.

4.43 As far as rural finance is concerned, several MFIs have gained a valuable experiences which is beneficial for both a better use of rural resources and the building-up of market-orientated practices in less favoured communities. Such experience could and should be further harnessed by providing MFIs with larger volumes of financial resources that are provided at market conditions. If this proposal is accepted, the role of MFIs could change from being an intermediary between banks and SMEs towards the role of direct lender, thus reducing the number of layers and with that the level of the financial intermediation costs.

4.6.3 Programme Manager of the Facility

4.44 The appointment of a Programme Manager (PM) or otherwise a working group between the EU/EBRD, participating banks and TA providers could contribute to the better performance of the Facility, assuming that such schemes are intended to provide larger amounts of loan funds over a shorter time span than a "traditionally" designed project. The main tasks that the PM/working group could have are: (i) assessing the needs of participating banks for TA tailored to each bank's specific requirements; (ii) drafting and overseeing the implementation of the marketing programme for bank lending services; (iii) organising meetings with business associations and SMEs in order to directly assess the programme performance and to explore the various potential improvements; (iv) reviewing with the participating banks the progress and the impact of disbursing loan funds under the Facility and suggesting solutions for improved performance.

4.45 The PM function could be carried out by a reputed independent bank expert who has a good knowledge of bank standards in the country, as well as of rural SME activities. S/he should act as a catalyst for attaining the best performance of the Facility.