# AN INITIATIVE TO RECTIFY A MAJOR INTERNAL FUNDING PROBLEM WITHIN AUSTRALIAN AGRICULTURE.

**TFI Ag** involves replacing inappropriate *financial* arrangements in rural Australia. Improved arrangements will secure and advance individual and mutual interests of three principals - food producers, financial intermediaries and food consumers – along with the national interest.

Current financial arrangements are clearly unsustainable. In Agriculture around Australia loans were made without due regard to servicing conditions or incomes. Serious problems accompany changes in loan and income conditions. Around $3b to $5b in loans appear contested[i], a figure that may rapidly escalate if actions are delayed.

Times have changed. Earlier industry adjustments occurred when asset values were rising, not falling. Today's situation is different, challenging and systemically risky. The first challenge is to allow individual debt write-downs without worsening current sectoral illiquidity or capital value losses[ii]. The second is to fund farming using apt financial arrangements.

Real solutions for today's circumstances are needed, not yesterday's empty chatter. Uncorrected past policy preferences can be destabilizing, or worse. This Initiative offers prudent solutions to funding problems, and a more sustainable path for Agriculture and its associated communities.

**Aim**: To put rural Australia on a sustainable funding basis by

A. reconstructing existing non performing loans (NPLs)
B. providing realistic, affordable finance;
C. developing a transition process that limits damage to
    a. the productive basis of Australian Agriculture and its contributions to the national economy;
    b. the financial system and its contributions; and
    c. the public interest and the Australian nation.
D. re-establishing sound industry and markets fundamentals for sustained profitability.

**Needs**:

A. a Reconstruction Agency, that optimally resolves NPLs
B. a Development Bank, that offers mutually viable funding
C. a transition management process, that minimises capacity and capital losses
D. a retained productive capacity and social cohesion reflective of a modern developed nation.

These are the focus of **TFI Ag** which can deliver mutually sustainable funding, noting of course that the problem of low profitability needs further consideration and policy response.

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**Proposition**:

The central proposition is that

A. an "**authority** " negotiate a "sustainable" debt level slightly higher than that achievable through market processes. The taxpayer is not asked to pick up the losses of existing commercial banks[iii]. Funders have the capacity to absorb losses. Adequate provisioning is in place - and they need to "clean up their books".
B. a "**Development Bank**" provide long-term and low interest loans that reflect the conditions faced by Agriculture. Existing Australian banks have been unable to do this, and without restructuring will not be able to do so.[iv] A Development Bank with its different objectives and more suitable conditions is a viable option[v].
C. an agreed "**transition process**" optimize the positions of all parties. Particular risks are considerably reduced, individually and overall. What none of us need is the mass sell down which will follow any large-scale market based adjustment, especially if contagion effects were to set in from one mortgage market to another.

The result is that valuable Agricultural operations and assets will operate on a more viable funding base. Over time, retained earnings can be expected to fund enterprise and industry development, and to allow sufficient reserves to be built to counter many natural disasters (things not achieved or achievable currently).

Individual and mutual losses are minimized and risks mitigated in this proposal.

- Commercial banks are advantaged by the higher than market "solution" outcome[vi] as the level of debt a business can carry is greater at lower rates of interest.
- Farmers will be restructured to manageable debt levels and sustainable interest rates are at or below net yield.
- The public's interests are served through continuing access to high quality foods at similar prices and more viable communities countrywide.
- The national interest is advanced by continuing - and over time, improved - contributions to the balance of payments on both merchandise trade and factor income accounts. (Foreign ownership sees factor incomes fall markedly and, if transfer pricing occurs, export earnings as well.)

At-risk bank capital is reconstructed along with stressed farm capability. Financial markets are de-risked by not having to fund enterprises with uncertain, volatile earnings. While some farmers *may* exit and new farmers *may* enter, both will be in a more advantageous situation than otherwise. This process makes responsible entry of new farmers much more feasible.[vii] Farmers will be able to focus on production rather than trying to deal with a financial product that fails to recognize the nature of their business and important rural peculiarities in the circulation of capital.

**Proposal**

It is unusual for this situation to be present, and it is clear both bankers and borrowers have erred in the borrowing and lending of funds based on (once) rising equity levels, rather than on available profits and incomes. Pre GFC funding arrangements are no longer viable, especially now with the termination of ECIRS and the lack of State cooperation with the recent Federal "Farm Finance" Initiative.

We seek an acceptable path forward for bankers and borrowers, and for the Australian public and nation more broadly. The four main elements in this proposal are captured in resolutions:

R 1. That a Reconstruction Authority be established.
R 2. That a Development Bank be established.
R 3. That a Managed Transition Process be established.
R 4. That these be established within the Reserve Bank of Australia by an amendment to the RBA Act by the Commonwealth Parliament.

Legislation to this effect is currently drafted and will be discussed with respective responsible parties in the next few days with an intention that it be introduced and passed within the current Parliamentary sitting.

This is a very tight frame but the problem is pressing and serious. There are signs of incipient sectoral collapses, regionally and continentally, where a disorderly workout would rob Australia of significant capabilities and incomes, along the food supply chain and as a Sovereign nation.

The interest and efforts of all are appreciated in improving the draft as we all work to maintain and improve our Common Wealth.

*Strengths*:

- addresses a critical national problem in a timely manner;
- allows an orderly workout of existing funding problems in a way that respects the interests of all principals;
- establishes a markedly more viable funding basis for Agriculture;
- reduces commercial bank sector losses and mitigates against serious potential risks;
- uses an existing agency that already has needed competencies and legislated authorities;
- prudently resolves a growing problem within a recognized respected, public authority;
- formalizes within the RBA an appropriate capability that may be used in other sectors if global and nominal national economic conditions deteriorate further;
- builds an advanced policy instrument for both normal and uncertain times;
- establishes one of two foundations for improved agricultural profitability and more sustainable Australian resource use; and
- supports continuing Ag contributions to the interests of Australians and Australia.

*Weaknesses:*

Let's sensibly address any so this Initiative may responsibly achieve best possible outcomes.

## Three Contexts

### *More Broadly: Revitalisation of Food and Fibre Industries*

**TFI Ag** is the first stage in moving Australian Agriculture to a more profitable and secure foundation. A second stage needs a "Food sectors Revitalisation Initiative" **FRI Food** addressing

a) food sector capability restoration and development,
b) market positioning and enhancement, and
c) policy review and revitalisation

The two Initiatives are complementary. The first, discussed in this Note, is needed with increasing urgency due to the accelerating decline in rural financial positions and the current lack of a suitable capacity to handle this. The second is considered in works such as ***"Repositioning Rural Australia"*** (ruraloz.net).

Profitable participation in the Asian Century requires **TFI Ag** and **FRI Food**. To date, rising food exports from high productivity sectors have seen miserable profits, stressed investments and depressed communities. This serves neither trading partners nor us well. No "secure supplier" status will be afforded under current funding arrangements. Australians need to establish ways that *all* can gain in a sustained and sustainable manner. **TFI Ag** helps deliver a desired future.

### *Rationalisation and other adjustments*

Extensive rationalisation has already taken place within Agriculture and related Food Sectors. "Rationalise - a quarter of farmers must go" was the cry in the late 1990s under the National's John Anderson as Deputy PM. So over 40% or 103 000 farmers went during the Howard-Anderson era, but no problems were solved. Having lost many small enterprises and much farm labour, Agriculture moved to a more capital-intensive basis. Many debts from amalgamating farms and purchasing machinery, plant and other equipment to operate the larger holdings are now in arrears. Trusts, listed companies and other holding arrangements are writing down assets or liquidating. The "30% of farmers who produce 80% of product" *lead* this crisis.

### *Banking system capability*

This Initiative sees rejuvenation of an important national capability that existed since 1911 with the foundation of a Commonwealth Bank owned and guaranteed by the Federal Government. The formation of the Reserve Bank of Australia in 1960 "to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia " with a specified third duty "the economic prosperity and welfare of the people of Australia", the *Development Bank* was allocated away from its conceptually more appropriate host[viii]. As part of the Commonwealth Bank group, the CDB was subsequently allowed to atrophy in an inappropriate commercial setting[ix]. This Initiative is in the spirit of such legislated directions.

Over 500 Development Banks operate globally, an average of 3 per nation. As they serve an important national purpose, they are distinctly different in purpose and design. *"In its original form and in its broadest definition, it is a type of financial intermediation to help the country reach a higher and sustainable level of development ... [and] fill a gap left by undeveloped capital markets and the reluctance of commercial banks to offer long-term financing"* ADFIAP or ruraloz.net

**Important further notes**

[i] ABA reports problems with 4% of member bank farm loans that total around $68b. Assuming a simple multiple would yield NPLs of $2.72b. This may be an understatement, especially if as it appears larger borrowings are involved. As some NPLs may yet to be declared, a working estimate of $3b to $5b is used.

[ii] Significant drops in prices for some farmland can reset capital values across the rural property market, worsening debt-equity ratios and sectoral risk ratings. Initial capital losses from a relatively small group of property sales can threaten a downward spiral. "Safe" farms can then be rated "at risk". When this occurred in commercial properties in 2008, the Commonwealth provisioned funds of $5b, and then $20b. Securities totalling $15b were finally held to halt imminent collapse in commercial properties. Five years later, it is starting to unwind this position. This Initiative involves a more active approach that would allow continuing farm activities, property maintenance, reconstruction and lower government holding costs and risks.

[iii] Write-downs currently attract considerable public subsidies through the tax system. They may also be offset by "insurance" (where the counterparty loses) through CDS and like devices. Funders then escape losses from failed lending. Where poor lending decisions incur no penalty, a situation of major moral hazard and market failure exists. Such a situation acts as an incubator of future crises so the authority would also play a preventative role.

[iv] The Federal Exceptional Circumstances Interest Rate Subsidy (ECIRS) effectively provided a guarantee when loan repayments fell behind due to drought and the like. ECIRS fluctuated around $1b annually over recent years while farm debts grew to over $60b. A needs-based 2% production subsidy by the public to Ag underwrote lending when farm incomes fell through no fault of farmers. ECIRS Termination in recent months terminated the de-facto guarantee and seems to have precipitated the current financial crisis.

[v] Not only are objectives and ethos different (development is the aim) but more flexible term and return settings allows losses to be lessened. Conditions are less onerous and more realistic than in a commercial bank product. In normal operation Development Bank losses are offset by profits - rather than the current situation where public subsidies offset losses incurred through use of inadequate lending practices.

[vi] Also avoided is the stigma that will come from a market-based adjustment. Outcomes will be "rather less than tasteful" throughout the communities of rural and urban Australia. We would expect overshooting of results as collapse got underway with a deep second-round adjustment as securities, already under pressure, fall come to extreme low levels when confidence is completely evaporated.

[vii] In many places no Australian purchasers are evident. New entry is stalled. Many existing farmers have lost confidence in the future to provide a reasonable living. This was demonstrated at the Roundtable when the WA contingent explained that in some districts every farm is for sale. Pressure are the same in the Northern cattle industry where some suggest more than 30% in default, in the dairy herds of Victoria where large numbers are being foreclosed. Such things demonstrate a failure of "the market" to provide viable solutions for rural conditions. Remember those under stress include very many successful farmers: they can produce and deliver products exceptionally well. Rural Australia is *facing a financial crisis* that threatens many communities across the nation.

[viii] *"But there is, I think, a case for specialist credit institutions which, while adhering to safe banking principles, make it their business to seek out, and assume risks in financing, smaller ventures in development. A public institution is in a somewhat better position to take a broad and long view… "* Arndt 1959

[ix] Initially Savings Bank funds were loaned to the Development Bank *despite markedly different risk profiles*. The CDB then competed with other commercial Banks for funds. *More will be said on this in another place.*

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