EXECUTIVE SUMMARY

The NSW Farmers' Association welcomes the opportunity to forward a submission to the Financial System Inquiry.

While deregulation of the Australian financial sector has made wholesale banking extremely competitive and resulted in a narrowing of margins, there has been little change in the competitive structure of retail banking upon which the rural sector relies.

The agricultural sector has several specific requirements and concerns that the Australian financial sector is currently not addressing. For example, there is an urgent need for financial institutions to provide full, accurate and open disclosure of information to customers. A more innovative approach by both government and the finance sector is required to address the present shortcomings.

The success of banking relationships depends on the capacity of financial institutions to understand and respond to client' needs. The profitability, competitiveness and sustainability of Australian agricultural will be strongly influenced by the ability of financial institutions to understand the cyclical nature of agriculture, provide appropriate and competitive products and develop long term relationships with their viable customers.

The retail banking market in Australia continues to be a highly concentrated oligopoly. Therefore, attempts to reduce the number of retail finance providers would be strongly opposed by the NSW Farmers' Association.

While it is recognised that technological advances are revolutionising the delivery of financial services to customers, it is critical that financial institutions make available appropriate information explaining how such services can be accessed and utilised.

SUMMARY OF RECOMMENDATIONS

1. That the profitability of financial institutions, the internal and customer margins and the fees and interest penalties charged, be specifically addressed in the Wallis Committee Inquiry.

2. That the government through the Reserve Bank, encourage financial institutions to apply the same margins to the rural sector as are applied to other non-rural loans with comparable loss experience.

3. That banks lower interest rate margins on loans to farmers to more accurately reflect the risk taken in farm lending.

4. That a review be conducted by government of the history of all rural related loans held by major banks over the last ten years to establish definitively the actual loss ratio and for this to be tabulated against each of the other lending categories.

5. That the government support rural industry by allowing rural loans, primarily secured over rural property, to be included in Tier 1 Prudential Capital Ratio at 75 per cent instead of 100 per cent as at present.

6. That financial institutions structure loan facilities to accommodate the irregular nature of farming enterprise cash flows, and not require straight line periodic payments which are unrealistic and cause default provisions to be activated with the associated higher costs.

7. That financial institutions incorporate into all lending facilities with the rural sector a three month penalty grace period to take into account the effect of weather patterns.

8. That financial institutions be encouraged to develop facilities with terms of up to 20 years for land and infrastructure development, at a competitive rate.

9. That the NSW Farm Debt Mediation Act be amended so that the essential principles can be implemented more effectively and that a "cooling off period" of 72 hours be introduced following the end of the mediation hearing and prior to signing of the Section 11 Certificate.

10. That government ensure the rural sector is appropriately serviced by:

    - existing banks; and/or
    - calling for expressions of interest from international financial institutions with rural expertise to establish operations in Australia which specifically target financial

servicing for agricultural production. This invitation to be accompanied by appropriate incentives.

11. That as part of its divestment of Commonwealth Development Bank the government ensures that the cash flow rural lending expertise is retained or transferred to another appropriate institution.

12. That financial institutions and the government commit to preservation of alternative financial transaction facilities, including the ability to make deposits and withdraw cash within rural communities.

13. That the government investigates the feasibility of Australia Post becoming a recipient/dispenser of cash in rural communities in the absence of a bank.

14. That financial institutions be encouraged to establish combined mobile branch facilities visiting rural areas on a regular basis.

15. That avenues for improving financial business and risk management skills, such as property management planning scheme be encouraged.

16. That financial institutions clearly indicate to clients on to lodge loan applications, which are accompanied by financial budgets and business management plans.

17. That the current Income Equalisation Deposit/Farm Management Bond (IEDs/FMBs) schemes be modified and that financial institutions be able to offer IED/FMBs.

18. That a person from the farm sector be appointed to the Board of the Reserve Bank.

19. That financial institutions who are the prime recipients of the Rural Adjustment Scheme (RAS) interest subsidy should be pegged to a uniform interest rate in the case of variable interest rate loans and not be allowed to get around this requirement by increasing bank fees and charges.

CHOICE, QUALITY AND COST OF FINANCIAL SERVICES

At present, the services provided by financial institutions do not meet the rural sector's requirements. More flexible and competitive products and facilities are needed.

Declining Services

The decline in financial services in rural areas imposes significant direct and indirect financial costs on rural enterprises.

Loss of services in local areas usually means an increased cost for the people affected, as they have to travel further and pay more for the necessary business, professional and personal contacts. There are other costs too, less tangible but just as real. Areas deprived of some basic services are unable to attract people to work there, which leads to further population loss and a continuing downward spiral in the range of services available.

Bank branch closures are of major concern to farmers and rural communities in general. In recent months a large number of closures have been announced throughout NSW.

While the NSW Farmers' Association acknowledges that the decision to close a bank branch is a commercial decision, the Association seriously questions the procedure adopted by banks in closing a bank. Most banks give three weeks notice of the impending branch closure. This time period is totally inadequate for rural clients given impediments such as slow postage services. More time is required for customers to be able to make contact with the closing bank and rearrange their finances.

Experience indicates, that is rare for personal contact to be made by the bank with their customers to advise them of the changes and ways to overcome the difficulties which might be experienced. More time and greater community consultation is required.

The closure of rural bank branches requires a commitment to the provision of alternative services such as bank agencies, "kiosk" banking facilities, automatic teller machines (ATMs), EFTPOS access, mobile bank officers, telephone banking and mobile banking.

While ATMs and EFTPOS enable cash withdrawals to be made, greater difficulty is experienced in depositing. Some ATMs simply do not have deposit making facilities. This is of great concern to farmers, given that the majority of their transactions are carried out by cheque.

One way of alleviating this problem, would be for governments to authorise Australia Post via its post offices and agencies, to receive cash deposits and allow withdrawals. This would be in addition to its current practice of accepting payments on behalf of power and water authorities, insurance agencies and banking institutions. It would be necessary to provide safe-guards against the loss of depositors' funds.

Also worthy of consideration, would be the provision of mobile banking services to communities without banking facilities. The mobile bank would act on behalf of all banks and process directly into the clearance system.

Options worthy of consideration include:

- existing banks, perhaps with some encouragement by government, developing their rural sections; or

- by a new government supported "rural" bank or financial institution (s) with Banking Act security for depositors; or

- by government inviting expressions of interest from overseas financial institution (s) with extensive rural expertise and focus to develop rural (on farm) operations in Australia, by granting special dispensations.

  These measures could include permission to operate as a branch of an overseas-based bank, differing capital adequacy ratios, concessional tax rates for the first ten years, abating for the subsequent ten years. Organisations that could be approached include Rabobank, which already has a presence in Australia and the French Credit Agricole. The invitation to Rabobank would need to be conditional on it agreeing to change its current lending focus. Rabobank would need to agree to increase their rural lending portfolio.

EFFICIENCY OF THE FINANCIAL SYSTEM

The Australian agricultural sector is one of Australia's most internationally orientated sectors, with approximately three-quarters of its total production exported. An efficient financial system is therefore critical to the success of the sector. The existence of inefficiencies in financial system raise the cost of capital to agriculture, which negatively impacts the sectors international competitiveness.

The retail banking sector remains dominated by the four major banks. Despite recording large profits in recent years, the banks have remained relatively high cost, high margin providers of retail finance. While the household sector has benefited from the entry of new credit providers, with the increased competition resulting in lower lending margins, such benefits have not flowed through to the rural sector. The sector continues to face high margins.

Evidence suggests that despite deregulation, major competitive failures continue to exist in the Australian financial system. The impact of these failures is especially high for sectors such as agriculture that deal with the banking system at a retail level.

It was envisaged that by encouraging foreign banks to enter Australia and compete with domestic banks, costs would be reduced and improved banking services would emerge. Evidence however indicates that the expected benefits from deregulation have been slow to materialise. Following an analysis of banking activity since deregulation, Milbourne and Cumberworth (1991) concluded that while wholesale banking margins have declined since deregulation, retail banking margins have actually increased. Indications from NSW Farmer's members clearly support this finding.

The concentration of competition from new entrants to the corporate lending area has contributed to this scenario. The new entrants into the banking sector have provided minimal lending to small to medium business sectors or to the household sector. The four major banks continue to provide the bulk of the finance to these sectors.

The rural sector has been significantly impacted by the noticeable decline in lending standards of the banks since the mid 1980s. In numerous cases, due to questionable lending practices, many Australians including farmers, have incurred significantly higher interest margins. This situation has led to the forced exit of many farmers from the industry, with others struggling to continue under heavy debt ratios.

Rural Adjustment Scheme (RAS)

It is crucial that community economic resources are efficiently used. Efficiency in this context means that community resources are used so as to maximise the productivity and the consequent wealth available to the community.

The bulk of assistance provided by the Rural Adjustment Scheme is in the form of interest rate subsidies. The NSW Farmers Association recommends that financial institutions who are the prime recipients of RAS interest subsidies should be pegged to a uniform interest rate in the case of variable interest rate loans, and not be allowed to get around this requirement by increasing bank fees and charges.

ECONOMIC EFFECTS OF DEREGULATION

The Impact of Interest Rates

Interest rates impose a significant direct and indirect cost on farmers. A high interest rate regime adversely affects rural producers due to their inability to pass the increased costs onto consumers.

High interest rates relative to those being offered overseas, attract foreign capital which can cause exchange rates to increase. Higher interest rates, while reducing the cost of imported goods, result in returns to exporters in Australian dollar falling and increased cost of development and working finance.

The period of high interest rates in the late 80s and early 90s imposed a double penalty on Australian farmers. Firstly, in a direct sense from higher interest rates and indirectly by reducing the returns to the export oriented agricultural sector through the rise in the value of the Australian exchange rate from high real interest rates attracting foreign capital inflows.

As identified by Naughton and Harvie (1996), the entry of foreign banks in to Australia may have contributed to the high interest rates experienced following deregulation. The situation as it arose in Australia from deregulation has been explained by Minsky (1980, 1982 and 1986 in Naughton and Harvie, 1996). Minksy's Financial Instability Hypothesis predicts that financial deregulation can lead to a boom in lending and eventually a crisis which is systemic in nature. The history of rural Australia following deregulation can easily be aligned with the Minsky Hypothesis. Years of excessive levels of speculation, inflation and interest rates were followed by corporate failures and a depressed rural economy.

PRODUCTS OFFERED AND IMPACT OF REGULATORY STRUCTURE

Due to the inherent nature of agriculture, such as the lead times in and variability associated with rural returns, the rural sector requires long term, low interest finance facilities. Financial institutions need to be encouraged to develop competitive facilities with terms of up to twenty years for land and infrastructure development.

The rural emphasis of financial institutions could be re-enforced by regulatory changes through the provision of extended powers or exemptions in relation to prudential ratios. For example, the ability to include rural loans at 75 per cent risk weighting for Tier 1 capital ratio, where primary security relates to rural property.

Risk Weightings

The risk weightings outlined in current Reserve Bank policy on the capital adequacy of banks, mean that rural lending is more expensive relative to other sector lending. Housing assets currently attract a risk weighting of 50 per cent compared to farm assets which attract a risk weighting of 100 per cent.

The Association firmly believes that the risk weights for farm property loans should be changed to better reflect the risk associated with those loans as compared with the risk associated with residential property loans.

Income Equalisation Deposits/Farm Management Bonds (IEDs/FMBs

Due to climatic uncertainty and variability, Australian farmers require a range of financial "tools" to enable sustainability, ongoing productivity improvements and to mitigate the effects of climatic variability. The provision of such tools, including an effective IED/FMB

scheme would be consistent with the National Drought Policy and would encourage preparedness and a self-reliant approach to drought and other economic downturns.
IED schemes commenced in 1976, with the latest IED scheme introduced on 1 July 1989. FMBs were established in 1993. Plummeting wool and beef prices and severe drought have precluded many farmers from being in a position to make use of these schemes and prepare for major climatic or economic induced downturns. This is especially the case for woolgrowers.

The existing schemes do not provide appropriate incentives to encourage farmers to use them. The low level of deposits currently held supports this view. In May 1996 there was less than $143 million in IEDs, and approximately $33 million in FMBs.

Proposed changes to IEDs/FMBs:

- **That IEDs and FMBs be available through registered banks under the Banking Act**.

  Some farmers prefer to deposit money with banks rather than Government. This proposal would increase competition among the financial institutions to the benefit of farmers.

  Banks are the major providers of finance to farmers. Many farmers rely on banks to provide the appropriate financial tools for effective farm financial management.

  Banks would have an incentive to offer and market IEDs and FMBs as appropriate financial management tools for their clients.

  It is also possible that financial institutions in making financial assessments, would favourably view the fact that funds are held with the institution in question.

- **That the existing IEDs and FMBs schemes be rolled into a new investment vehicle.**

  The primary role of IEDs/FMBs should be:

  - to encourage farmers to set aside reserves for cyclical downturns; and
  - to extend the national policy of saving to the rural community.

  One way to achieve this objective would be to revise the existing schemes into one effective, simple to operate and easily understood operation. The emphasis should be on the conservation of income in good or bumper years rather than, as is the case presently, the disposal of good year’s incomes in the most tax effective manner. Such actions deplete the available cash resources of the farming enterprise for the sake of minimising the taxation liability.

- That the monies placed into the new vehicle be fully tax deductible in the year of deposit and fully assessable, including the interest component, in the year of withdrawal.

- That the withdrawal provisions allow for withdrawal during economic and business downturns.

- That the implementation of taxation effective rollover provisions upon retirement and taxation effective withdrawal provisions upon death be introduced.

- That the maximum limit on deposits be $300,000 (indexed annually) or annual farm turnover, whichever is greater.

While the Association recognises the constraints in clause 4 (d) of the Inquiry's Terms of Reference, it invites the Inquiry to observe that Section 23G of the Income Tax Assessment Act acts as an impediment to the establishment and viable operation of mutual non-bank financial institutions. The NSW Farmers' Association draws your attention to the Bananacoast Community Credit Union Ltd submission to the Wallis Inquiry.

TECHNOLOGICAL AND MARKETING ADVANCES

Technology

The NSW Farmers' Association recognises that recent technological advances have enormous potential for primary producers. It is important that services and facilities tailored to the needs of primary producers, are developed and promoted.

Marketing

Banks need to increase their capacity to provide expert financial assistance to the farming sector by expanding the quality of their resources in areas responsible for rural lending.

There is real need for financial institutions to develop resources and advisory services to assist farmers to understand the assessment requirements of banks. Financial institutions should encourage clients to seek independent advice.

Financial institutions must operate on the basis of full disclosure. A commitment by financial institutions to full disclosure, needs to be reflected in the marketing of financial products.

Perception problems associated with alternative transactions methods need to be addressed by the financial institutions.

DOMESTIC COMPETITION

Despite deregulation, the retail banking market in Australia continues to be a highly concentrated oligopoly.

Improved competition amongst finance providers to the rural sector is vital, if the sector is to continue to create wealth and generate employment opportunities. The growth of the farm sector will continue to be seriously impeded until inefficiencies inherent in the finance sector are reduced and ultimately removed.

Transaction Costs

One barrier to an efficient capital market arises from the high transaction costs in transferring loans between institutions. Even where loan security duties for making transfers between industries are waived, there are still significant costs imposed by the banks for items such as solicitor fees and searches, their own initial charges for loan establishments, and penalty charges. These charges are of a significant level and lock in borrowers to a certain degree and thus restrict competitive pressure. The impost of penalty charges such as those associated with account closures and transferring loans, is of particular concern given the increasing incidence of bank closures in rural areas.

Unfortunately in NSW, recent changes to stamp duty have seriously disadvantaged primary producers. Primary producers are now only eligible for a Refinancing Exemption under Section 84CAA of the Stamp Duties Act, if the property used for security, the borrower and the balance of the loan security remains the same. If any of these conditions vary, no exemption is available. Prior to 1 June 1996, primary producers were eligible for a refinancing exemption if the loan security remained “substantially the same”.

High penalty loadings applied by banks to accounts which are experiencing cash flow problems make it much less likely that the enterprise will be able to recover and resume profitability.

The imbalance in terms of size and market power between banks and customers and the continuation of prohibitive transaction costs, limits the capacity of the market to operate efficiently.

The NSW Farmers’ Association is concerned at the obvious lack of price competition in rural lending and is therefore is strongly opposed to any further concentration in the banking sector.

The Effect of Margins

Financial institutions derive income from:

- Internal margins - the difference between fund raising and fund lending indicator rates;

- Customer margins - the price at which the assessed risk is measured;
- Fees and charges - to deposit and loan customers, and for other financial transactions;
- Profits from trading in financial products, such as, foreign exchange, interest rates, futures and shares.

Economic recovery has seen marked improvements in banks' financial performance, following the heavy debt write-offs from mainly non-farm loans and activities during the recession years. Whilst margins have fallen as profits have attracted increased competition, the main beneficiaries have been home loan borrowers. Unfortunately rural lending margins have not fallen, with evidence suggesting that they have actually increased.

The NSW Farmers' Association recognises that financial institutions have a corporate responsibility to maximise returns to their shareholders. The rural sector however should not be used to prop up losses in other areas of the banks' activities, for example, underwriting property developers. Financial institutions need to adjust their perspective of the credit risk element, as reflected in the customer margin. The customer margin for well secured small to medium-sized businesses compared with current home loan interest rates represents a difference of approximately 3 percentage points. This appears to be excessive.

This is especially the case for agricultural loans which have a lower default rate than business loans. Bad debt write-offs in the rural sector are approximately 1.42 per cent of loans, which is substantially less than real estate/construction sector of 9.24 per cent, commercial loans at 2.45 per cent and credit card losses at 6 - 9 per cent. The implied margin for information costs, is therefore approximately 1.6 per cent (3 percent customer margin, 1.4 per cent default rate) (Barnes, 1996). This is unjustifiable given that the majority of loans now include fees and fixed charges to cover administrative costs. The margin for information costs is less than one percentage point.

These statistics indicate that the level of risk attached to farm loans is less than it is perceived to be. If loans to the rural sector had a comparative margin for information costs as other commercial loans, then the interest rate on rural loans would be approximately one percentage point less than it currently is.

These inequitable high margins could be addressed through greater competition in the provision of lending to the rural sector.

CONSUMER NEEDS AND DEMAND

Services currently provided by financial institutions do not meet the rural sector's requirements in terms of flexibility or appropriateness of facilities offered. Due to current staffing practices of the financial institutions, few employees have an understanding of the rural sector and its cycles. For example, the impact of drought on the debt servicing ability of farmers.

There is a need for rural support sections to be promoted within financial institutions.

Financial institutions need to structure debt facilities, taking into account the seasonality of the farming enterprise the money is lent to, and not assuming straight line monthly cash flow serviceability.

Code of Banking Practice

There is an urgent need for the implementation of an effective and equitable Code of Banking Practice covering all credit and financial arrangements reached between farmers and financial institutions.

In 1991 during the Martin Inquiry, all banks agreed to expedite a "Code of Conduct". It is understood that the implementation of the Australian Bankers' Association (ABA) Code of Banking Practice dated 3 November 1993 has been delayed due to its link with the Uniform Consumer Credit legislation which does not take effect until 1 November 1996. The NSW Farmers' Association never signed off on this Code of Banking Practice.

The NSW Farmers' Association invites the Inquiry to examine the unacceptable attitude of the banking sector towards this Code.

The Association recommends that a review of the Code commence in November 1997, one year after its introduction.

The NSW Farmers' Association believes that the ABA Code of Banking Practice does not adequately redress the imbalance of bargaining power between lenders and farmers.

Further, banks should not have retrospective powers in relation to fees or charges. The Code of Banking Practice should prohibit banks from inserting clauses which allow for additional fees, charges or variations to the way in which interest is calculated, without agreement of the client.

The Code should also prohibit banks from inserting clauses relating to changes to interest rates and charges without full disclosure and agreement by the client. Effective interest rates on bank statements and loans must be fully and continually disclosed.

In the current environment, it is very difficult to compare borrowing costs due to the myriad of and ways in which fees and charges are being applied by financial institutions. Effective price competition is therefore not being achieved. The current situation allows banks to effectively mask the total cost of a lending facility.

Given the failure of the banking system to address this situation, the NSW Farmers' Association would support Government intervention to introduce a standard that reduces all borrowing costs to a single figure, namely, the annualised total cost (ATC). This rate should be available to all customers. The existence of such a rate would enable consumers to compare products.

Full and open disclosure of banks' service costs will lead to free market competition which will be of benefit to both borrowers and lenders.

Farm Debt Mediation

Banks are in a unique and privileged position which gives them an imbalance of power when confronted with disputes. This power imbalance is clearly demonstrated in situations involving Farm Debt Mediation in NSW. Areas in which the Act is currently not working is the failure of banks to act in "good faith". In many cases, the banks are paying little more than "lip service" to the process and are not acting in good faith.. This attitude is leading to costly and time consuming legal procedures.

The NSW Farmers' Association supports the principle of Farm Debt Mediation. Evidence however indicates that in practice the existing NSW Farm Debt Mediation Act is not working well and that amendments to the current legislation are warranted. The NSW Farmers' Association proposes the introduction of a "cooling off period" of 72 hours following the end of the mediation hearing and prior to the signing of the Section 11 Certificate.

PROVISION OF TECHNOLOGY, SERVICES AND MARKETS

All Australians should have access to efficient and competitive financial services. Given the declining access to traditional methods of banking for many rural Australians, there is a real need for the financial institutions to develop appropriate information packages and offer training to familiarise people with alternative transaction methods such as EFTPOS, ATMs and telephone banking.

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