RURAL INDUSTRIES RESEARCH
& DEVELOPMENT CORPORATION

Efficient Equity and Credit Financing for the Rural Sector

New directions in rural and agribusiness finance

Conference Report and Proceedings

A report for the Rural Industries Research and Development Corporation

by Dr T. M. Dwyer, Asia Pacific School of Economics & Management and R.K. Lim, Bob Lim & Co. Pty. Ltd.

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Foreword

This Conference, and the research and planning which was necessary for its success, has brought together financial sector and rural and agribusiness sector expertise to take a new look at the issue equity and credit financing for the rural sector.

Rural finance has had a long and sometimes turbulent history in Australia. This Conference was not intended to go over old ground but rather to look at whether, and in what ways, Australian agriculture can be more effectively integrated with Australia's highly sophisticated and internationalised financial sector. As the Conference *Issues Paper* points out more effective integration would result in productivity gains and further enhance Australia's international competitiveness.

This Conference Report and Proceedings publication should serve as a useful reference volume for Conference participants and for the financial and rural sectors generally. It is hoped this Conference will help in charting new directions and innovations in rural finance instruments.

This project was funded from RIRDC Core Funds which are provided by the Federal Government.
This report, a new addition to RIRDC's diverse range of over 700 research publications, forms part of our Global Competitiveness R&D program, which aims to identify important impediments to the development of a globally competitive Australian agricultural sector and support research that will lead to options and strategies that will remove these impediments.

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Peter Core
Managing Director
Rural Industries Research and Development Corporation

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RIRDC funding has been instrumental in enabling the research and planning which underpinned this Conference. In particular we wish to thank Peter Core and Jeff Davis of RIRDC for their encouragement and support. We also acknowledge the assistance of David Ginns, Agribusiness Association of Australia and of Jim Gale and Catriona Wyatt and their colleagues at CEDA who helped organise the Conference so efficiently. Finally, we also thank all the speakers and participants at the Conference.

About the Researchers

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Dr Dwyer holds the degrees of Bachelor of Arts (Honours) and Bachelor of Economics (Honours) from the University of Sydney and Master of Arts and Doctor of Philsophy in Economics from Harvard University. He has been awarded numerous prizes and scholarships in the course of his distinguished academic career, including the award of a Harkness Fellowship in 1976 and the Joseph A Schumpeter Fellowship in 1979 for study at Harvard University. He is a member of the Economic Society of Australia, the Australian Tax Research Foundation, the Harvard Club of Australia and a life member of the American Economic Association.

Robert Lim

Is a senior economic and policy consultant, formally Chief Counsellor to the Committee for Economic Development of Australia (CEDA) and a former Director of Policy Analysis and Research at the Business Council of Australia. Mr Lim's firm, Bob Lim and Company, specialises in economic and regulatory issues in access and pricing for energy infrastructure. Mr Lim was a senior official in the Department of Foreign Affairs and Trade in Canberra. He has served on numerous overseas economic assignments, including as Minister (Commercial) Australian High Commission, London from 1988 to 1991, and was Visiting Fellow at the Australian Studies Centre, University of London from 1982 to 1985. Mr Lim was head of the Australian delegation at numerous international commodity and trade negotiations. He was previously Chairman of the Executive Committee of the International Sugar Organisation, London. Mr Lim also worked as an economist in the Commonwealth Treasury and the Reserve Bank of Australia.

Mr Lim holds the degree of Bachelor of Economics from Monash University and is a graduate of the Advanced Management Program at The European Institute of Business Administration (INSEAD), Fontainbleau.

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1 Introduction

1.1 Background

The Conference *Efficient Equity and Credit Financing for the Rural Sector: New Directions in Rural and Agribusiness Finance* took place on 14 June 2001 at the State and Regional Development Conference Centre, Grosvenor Place, Sydney.

The Conference Agenda, Speakers Biographical Notes and Attendance List is provided at Appendix 1.

1.2 Objectives of the Research and Conference

The objectives of this project were to take a fresh look at the subject of rural financing in Australia. While previous studies in rural finance have concentrated attention at the farm enterprise level, this project has taken a "tops down" approach to the issue by considering from a financial sector viewpoint how, and in what ways, rural and agribusiness financing differ from mainstream contemporary practise in the financial sector, including, in areas such as securitisation, mezzanine financing, etc. A number of key questions were posed, for example, has Australian agriculture been left behind in the financial evolution of the 1980s and 1990s? Can securitisation of agriculture in Australia be progressed? What legal, taxation and regulatory obstacles exist to more effective integration of agriculture with contemporary Australian financing techniques?

The Conference was designed to open up these theme issues for discussion from the viewpoint of financial sector experts, academics, legal practitioners and rural and agribusiness operators. Papers and presentations were provided from these sectors, focussing on the Conference themes, with a final Panel Discussion to reflect on future directions and close the Conference.

The Conference proceedings, and the supporting documentation, provided in this Report is intended to be a reference source for further research and assist in deepening the integration of Australia's financial and rural sectors, and thereby improving Australia's international competitiveness.

1.3 Methodology

Key developments and evolution and change in Australia's financial sector, and the rural sectors, were researched and key academic and professional business publications were reviewed to distil the central issues. An *Issues Paper* was then prepared and reviewed by an expert Reference Committee. This is provided at Appendix 2. The Conference was then developed and organised around key themes with the purpose of exposing the topic, as elaborated in the *Issues Paper*, to discussion and analysis from a range of expert viewpoints. The *Issues Paper* was distributed to participants prior to the Conference to assist in discussions. The Conference Report, including Papers and Proceedings was then prepared.

1.4 Structure of this Report

Chapter 2 distils the themes and outcomes of the Conference. Chapter 3 canvasses possible areas for further research arising from discussion and papers presented. The Conference Presentations and Discussion is provided in Chapter 4. Appendices provide the Conference Agenda, Speakers' Biographical Notes and Attendance List, and the Conference *Issues Paper*.

2. CONFERENCE THEMES AND OUTCOMES

The Conference was successful in clearing the ground for a better understanding of the special needs of rural finance in a de-regulated financial market and charting the way forward firstly in further essential research and ultimately in commercialisation. Key themes and outcomes to emerge were:

First, there was general agreement that primary industries, run on a commercial basis, could be and were profitable. The "eighty- twenty" rule where 20 per cent of producers accounted for 80 per cent of the output was noted. The low profitability of marginal producers should not be allowed to obscure the real productivity and profitability of agribusiness. Primary production industries were not dead or dying. New industries such as horticulture, viticulture as well as new interest in forestry and beef were auguring well for rural Australia while in industries subject to new competition such as dairying, there were producers who were achieving productivity and profitability gains which would allow them to prosper.

Second, it was noted that there were serious obstacles to rural financing created by the ownership structure of most producers. Because most producers were organised as private companies, partnerships or trusts, they had no access to outside equity finance from the public or from institutional investors such as mutual funds or superannuation funds. There was an acknowledged gap in equity financing and most primary producers, except for some corporate operations, had no access to public equity markets or to private placements with institutions.

Third, there were tax obstacles to equity investors in agriculture. Like venture capital and new technology start-ups, primary industries experience great variations in returns often over long cycles. Unless losses and depreciation allowances flowed through as incurred to ultimate investors, the net rate of return to investors was more depressed compared to other activities such as real estate where returns tended to be steadier. In extreme cases, the inability of primary producers to set off losses against off-farm income could lead to insolvency. This was a problem for companies and trusts and explained why small producers tended to use partnerships for their operating structures. Paradoxically, where investors could access losses, as in agricultural tax investment arrangements, there was no shortage of potential investors but these "tax driven" investments often faced challenge from the Tax Office, had high administrative costs and were not generally available to raise equity investment for all primary producers. Their significance lay more in showing that a neutral or "flow through" tax treatment for primary production like the US limited partnership model would be significant in unlocking external equity investment in agriculture.

Fourth, there were superannuation prudential restrictions which have had the effect of diverting funds away from rural investments. Because of prohibitions on "in house" assets, superannuation savings of rural Australia were often not re-invested back in rural industries in the areas from which they came. This might not matter if other funds were forthcoming, but given the obstacles to equity investing in primary producers for institutions, this was not the case.

Fifth, there was investor interest in agriculture. The "tax driven" schemes showed as much. But, as always, it is a question of risk and rate of return. Investors who lack "hands on " control have often lost money in agricultural investment. Equity investors would be interested in tradeable, liquid securities of primary producing businesses but these are not generally available.

Sixth, that there was scope for equity finance to replace debt finance in primary producing enterprises was illustrated by the observations that margins on banks' loans to agriculture were among their most lucrative. For banks and pastoral finance houses which had been able to take the long view, rural finance had been generally profitable.

Seventh, there was no apparent in principle difficulty to securitising rural output as a means of obtaining finance. But the problem was one of "fine tuning" the design of any such product to maximise its market and, most importantly, one of pricing. Unless rating agencies have a track record on which to grade an investment security, investors cannot price it fairly. If they cannot price it, the risk premium they will add to their implicit rate of return may make the equity finance too costly for a primary producer compared to conventional bank debt financing.

Finally, the importance of securing the broadest possible base for funding investment in Australian agriculture was brought home by the potential impact of globalisation. National banking systems were becoming less important as agents of domestic economic investment and development while global equity markets were becoming more important. Japanese banks, for example, could not "lend through" the negativity of the Japanese and world stock markets on Japanese industry. Australian agriculture was no longer the beneficiary of a directed pool of development funds and now had to compete with other enterprises seeking funds across the globe. If Australian agriculture was "off the map" for Australian fund managers, this would be more so for overseas fund managers. Part of the United States' success in the world economy lay in its ability to improve and perfect its capital markets which had led to an inflow of global funds to US markets, simply because they were there. Countries and sectors without capital markets do not get capital; and countries and sectors with less developed capital markets, get less capital for their development.

3. RECOMMENDATIONS FOR FURTHER RESEARCH

The Conference demonstrated an acknowledged gap in sources of funding for Australian agriculture. On the one hand there was no obvious route for public equity investment in Australian agriculture, while, on the other, Australian agriculture faced equity limits on the amount of bank debt it could shoulder.

The obvious line of further research which commends itself is to examine how this impasse can be broken. This, like many examples of innovation, is an issue which is unlikely to be solved by purely private sector initiative, because public policy and legislation impinge on any development of new forms of capital raising and the benefits cannot be appropriated solely by the innovators – there are no patents of monopoly granted on new financial products. Faced with an analogous problem in the 1980s, when funds for housing through thrift institutions dried up, the US Government supported the development of markets for standardised mortgage-backed securities so that a national mortgage market could arise and pension funds and other investors could fill the hole in the market created by the collapse of savings and loan institutions.

Fortunately, Australian agriculture does not face a funding crisis of these dimensions and, while there have been complaints of banks gradually withdrawing loan support from marginal farmers, banks continue to lend to profitable and solvent producers. However, the ability of banks to lend as generously or for as long as they once might have has been affected by financial deregulation, capital base requirements and the rise of competing repositories of funds. Australian primary industries have no choice but to look at diversifying their funding bases with new and innovative financing techniques and instruments tailored to contemporary best practice in Australian and global financial markets.

Securitisation of Australian agriculture is, therefore, an objective which should be pursued to the mutual advantage of both Australia's agricultural and financial sectors. An example might be the development of standardised generic crop securities which can be traded, registered, quarantined from insolvency and tracked for financial performance by ratings agencies. Once such securities exist, their agglomeration into diversified crop pools available for public and institutional equity investment would play a "completing role" in raising capital for the primary producers of the crops. Companies sell shares because investors would to buy a share of their future profits; primary producers could sell crop securities to investors willing to buy an equity stake in future crop deliveries.

The development of markets for agricultural securities will involve progressing a detailed research agenda and the commercial fulfilment will involve interaction with regulators, investment bankers, farm organisations, marketing boards, fund managers, ratings agencies and exchanges. In the United States, it took several years and considerable input from government agencies and statutory authorities to perfect securitisation of home mortgages. No one group can be expected to devote the resources necessary to secure an analogous, but more complex, achievement for financing Australia's primary producers. But the sooner a research agenda to solve the problem of "filling the equity gap" in funding Australian primary industries is progressed, the sooner rural employment and investment opportunities can be unlocked.

4. CONFERENCE PRESENTATIONS AND DISCUSSION

Editorial Note: *The following record of presentations and proceedings of the Conference has been assembled and edited from the papers delivered by speakers, power-point presentations and recordings of the discussion sessions.*

Morning Session Chair: Mr Jim Gale, Executive Director, CEDA

4.1 Issues and Conference Structure

Dr T M Dwyer, Visiting Fellow, ANU

Before proceeding I would like to acknowledge on behalf of Bob Lim and myself the support of the Rural Industries Research and Development Corporation which has made this conference possible. Both Peter Core and Jeff Davis have recognised that enhancing the global competitiveness of Australian primary producers embraces a wide range of issues. Without that breadth of vision and support from RIRDC this Conference would not be happening. I should also acknowledge the assistance of Todd Ritchie, formerly director of economy policy of the National Farmers' Federation, for his insistence that rural finance was not an obsolete issue but, in fact, an issue that needed to be looked at again in a holistic context, and in that context I should acknowledge a paper prepared for him by Chris Ambler, who I notice is present, on equity finance for rural Australia. Also, we do acknowledge, of course, the support and interest in this subject shown by both National and State Farmers' Federations. We are also particularly pleased that the Agribusiness Association of Australia and CEDA have joined forces in making sure that this will be a successful Conference, and the presence here later today of a Parliamentary Secretary and a Shadow Assistant Treasurer remind us of the importance of primary production for the nation and those responsible for policy at the highest levels.

I must now briefly summarise the major issues we will be addressing. I have tried to be concise and reduce these issues to their baldest expression.

First – is there a problem? Some people would argue, notably Treasury officials I suspect, that there is no problem with rural finance, that markets are always efficient and that after deregulation any complaints you might hear about rural finance inadequacies are merely the remnants of vested interests which have lost access to preferential financing. Now I suppose a stock market analogy to that sort of way of looking at it would be the efficient capital markets hypothesis with which many of you will be familiar. But in its extreme form that hypothesis suggests that markets always work, they are always right, and we could save ourselves a lot of money by getting rid of all superannuation fund managers because there is nothing for them to do.

Second – is primary production profitable? There is no point raising finance for unprofitable businesses. Some people would say the official statistics show that agriculture has tended to be relatively unprofitable in terms of return to assets employed. Others would say the statistics are misleading and distorted by the presence of so-called producers who are not operating on a commercial basis. Many would argue that long term cyclical variations in profitability are common

to primary industries and that short term profitability statistics in an era of "short termism" are merely a waste of time.

The ***third*** issue we have highlighted is – have financing channels changed? Now those who suggest there is a problem emerging in rural finance will focus on changes in the channels of finance. Have there been structural changes in the financial sector? Have banks lost out to superannuation funds and managed funds in controlling the direction of Australian saving? Are some sectors better able to tap into international credit or equity flows than others?

The ***fourth*** issue is – is there a gap between debt and equity finance? It is well recognised that companies are becoming much more sophisticated in their liability management, with buy-backs, recaps, convertible preference shares and so on. Companies are showing a great agility in managing their liability structure to better manage their needs. But traditionally most primary producers have been smaller scale agribusinesses reliant on owners' equity and debt finance from banks or pastoral finance houses. Has bank debt been used in the past in circumstances which should now call for injection of equity or quasi-equity finance? Are rural enterprises pressed to increase their size and capitalisation to be competitive on the one hand, but unable to raise the necessary funds on the other? Is there a gap between the equity which owners can inject and the debt which banks or other lenders are willing to supply?

The ***fifth*** issue we will be coming to is – are there tax or other regulatory impediments to attracting domestic or overseas investors? Because primary production is an industry with variable returns, the tax treatment of losses or flows of capital into and out of rural enterprises can have a very significant effect on its net rate of return – more so than in the case of activities like real estate where there is generally more steady and predictable returns. Are there features of tax, securities regulation and superannuation regulation which make primary production enterprises less attractive to investors or in other ways inhibit the owner's ability to ride out the inevitable variation in profit and loss? In this context I note that a former Assistant Treasurer, Mr George Gear, has been quoted as saying the greatest deterrent to investment in rural Australia is the Australian Taxation Office. Is there merit or point in such complaints?

The ***sixth*** issue is – can primary production benefit from what you might term the securitisation revolution? If there are gaps in rural finance can the sorts of financial innovation which have seen the securitisation of home mortgages and various kinds of receivables be adapted to create new ways for primary producers to raise capital safely from outside investors? And when I say safely, I mean safely for both sides. If more and more of the world's stock of financial capital is being deployed by institutional investors, such as pension funds looking for tradeable securities, how does Australian agribusiness tap into such sources of funding?

Seventh – can hybrid securities be developed to bring together investors and primary producers? Securitisation has generally been referred to as a bundling up and reselling of *debt* claims to institutional investors. Can a similar approach be adapted for hybrid quasi-equity or mezzanine finance, and can that be done in such a way that is largely independent of the legal form of the enterprise?

This Conference is an opportunity to explore these issues and we hope that everyone here will feel free to contribute to that exploration. I should like to thank you in advance for your attendance and hope that we all contribute to developing discussion on what is I think very much a non-trivial issue. Finding the most efficient financial technology to develop Australia's rural industries should be no less interesting for us here today than it was for the USA, Germany or Japan in the nineteenth century.♦

4.2 Opening Address

Senator the Hon Judith Troeth, Parliamentary Secretary to the Minister for Agriculture, Fisheries and Forestry

Introduction

Official guests, ladies and gentlemen, I am delighted to be in Sydney today to open the *Efficient Equity and Credit Financing for the Rural Sector* Conference.

I would like to take this opportunity to talk to you about what the Government is doing to help our rural and agribusinesses move forward in new and promising directions. This is something that I am sure your Conference today will help promote even further.

Scene setting

The Australian agricultural sector presents both opportunities and challenges for governments and financiers.

Ours is a vast continent with enormous capacity to produce fresh and processed food, food commodities and fibre products to supply the world, but with some major constraints in terms of our climate and sustainability. We are also well aware that our producers operate in an international trading environment plagued by subsidies and distortions.

Even so, Australian producers have been able to compete successfully by being among the most efficient in the world.

In an environment that emphasises self-reliance and market responsiveness, it is up to producers to manage their businesses to maintain a competitive edge and to safeguard their future through sustainable practices.

The challenge for Australian governments is to play a facilitation role in this essentially market driven environment.

Government portfolio initiatives

The Government's approach to agriculture, fisheries and forestry policy has been to focus on providing producers in rural and regional Australia with greater control by delivering programs that support and encourage the success of agriculture into the future. These efforts are focussed on several different areas.

First, strong economic management is a major priority for this Government to ensure a macroeconomic environment conducive to the strong growth and long term profitability of agricultural businesses. This year's Budget has a surplus of $1.5 billion — the sixth surplus Budget in a row. Net debt has fallen since its peak of 20 percent of GDP in 1995-96 to just 8.4 per cent of GDP at 30 June 2000. In dollar terms, the Coalition Government has now repaid nearly $60 billion of Labor's debt. Australian homebuyers are now paying $3,000 less a month for the average home mortgage than they were paying when the Coalition was elected in 1996. Economic growth is set to rebound during 2001-02 to 3.25 per cent with solid employment growth holding unemployment steady at around 7 per cent.

Secondly we are making a strong effort to encourage the development and uptake of new ideas and approaches for business and agriculture through major investment in innovation, research and development — this was boosted significantly earlier in the year by the Prime Minister's innovation statement - *Backing Australia's Ability* — by $2.9 billion;

We are providing for increased sustainability through natural resource management initiatives, such as the Natural Heritage Trust and, more recently, the National Action Plan for Salinity and Water Quality in Australia;

Maintaining and improving the quality of Infrastructure is also important if we are to attract investment in rural and regional Australia. For that reason, the Government is investing $147 million over five years to improve rural and regional telecommunications and Internet services. $850 million is being spent on roads in rural and regional Australia as part of the $1.6 billion Roads to Recovery Program.

Specifically for agriculture, we have the Agriculture - Advancing Australia package — 'our AAA' which is quite distinct from one of our conference sponsors today, the Agribusiness Association of Australia. Through our AAA package the Government is encouraging self reliance by training producers in the areas of risk management and farm business planning, with programs such as the FarmBis Program; and lastly we are delivering community initiatives aimed at overcoming social disadvantage in regional areas, for example the Regional Solutions and Farm Help programs.

The Government's success in ensuring a macroeconomic environment conducive to the profitability of agricultural businesses has been achieved through prudent monetary and fiscal policies and is evident in Australia's low underlying inflation rate, reduced government debt and low interest rates.

The Government is working hard to assist producers to take control of their own affairs and to develop stronger rural communities.

This is being achieved by maintaining a business climate conducive to growth, supporting better natural resource management, encouraging innovation and facilitating industry adjustment where that needs to occur.

The 2001 Federal Budget and ABARE projections

This year's Federal Budget will help to ensure that regional Australia's contribution to national economic and social wellbeing is both safeguarded and enhanced.

Over the next five years, the Federal Government will provide $21.7 million through the New Industries Development Program to support Australian agribusinesses in gaining the business skills and resources required to successfully commercialise new agribusiness products, technologies and services.

The greatly expanded and enhanced New Industries Development Program will boost efforts to improve Australia's performance in the development and commercialisation of new innovative agribusiness products, services and technologies.

The commercialisation of market driven solutions based on innovation is central to the expanded program. Through initiatives supported under the enhanced program, Australian agribusiness enterprises will gain the business skills and resources required to successfully commercialise new agribusiness products, services and technologies.

The benefits of business and job growth will flow through to rural and regional Australia.

While we hear a lot about the value of our agricultural commodity exports and what this means to rural and regional Australia, I believe there is still huge untapped potential for our fresh and processed foods to be exported.

Processed foods are the fastest growing component of world food trade and now account for around 75 per cent of global trade in food. Between 1994 and 1998 world exports of processed food grew 7.9 per cent. The worrying thing for Australia is that during this period, our exports of processed food grew by only 1.8 per cent.

Clearly, Australia's global market-share is declining. Our exports remain largely commodity based or minimally processed.

For this reason, the Minister for Agriculture, Fisheries and Forestry, Warren Truss, announced the development of a National Food Industry Strategy in March this year.

To make this happen, the Government has provided $3 million in this year's Budget for the development of a National Food Industry Strategy to help secure the future success of our food industry.

The aim is to put in place a strategic framework of actions for both industry and Government for the growth of a sustainable, innovative and globally competitive Australian food industry in an era of increasing globalisation and free trade.

Over the past few weeks I have been leading the consultation phase with a series of meetings throughout Australia to gather views from people in the industry as to what is needed to improve our performance in this area.

The Strategy will be developed jointly by the industry and the Government. The industry is leading in identifying issues that need to be addressed and ways to deal with them. The Government will facilitate in the development of the Strategy and deal with issues that are identified which are its responsibilities.

The National Food Industry Advisory Committee, which comprises senior representatives of the major segments of the food industry and related service industries, has been established to drive the development of the Strategy.

Our aim is to have a final report prepared, for the consideration of Cabinet in September.

This Budget also includes a commitment of a further $1 billion for the Natural Heritage Trust and delivers on the Government's $700 million commitment to the National Action Plan for Salinity and Water Quality.

The Federal Government has responded decisively to concerns about disease and pest outbreaks around the world with the strongest level of quarantine protection against exotic pest and disease risks ever provided in Australia.

Our clean green reputation underpins agricultural exports worth about $24 billion a year so it is vital that we safeguard our disease-free status. Should foot and mouth disease, in particular, enter Australia, export markets for wool, meat, dairy and live animals worth almost $15 billion a year could be compromised.

The additional budget funding of $596 million will allow the reinforcement of quarantine measures across-the-board to protect the nation's vital agricultural industries and the environment for a wide range of disease and pest threats.

The Federal Government will provide $26.4 million over the next four years for a new Agricultural Development Partnerships program, which further demonstrates our commitment to regional and rural Australia.

These partnerships will assist industries or regions facing severe structural adjustment pressures to seize control of their own destinies and to reposition themselves for future growth and prosperity.

The Agricultural Development Partnerships program will support local initiatives to increase the profitability, competitiveness and sustainability of the local agricultural industries and enhance the management of the natural resource base and promote stronger rural and regional communities.

According to the Australian Bureau of Agricultural Resource Economics' (ABARE) recent Farm survey it is expected on average, that broadacre farm cash incomes will rise by 10 per cent. In fact, the rates of return for all Australia's broadacre industry sectors are expected to be positive for 2000-2001 — the first time since 1989-90.

Before I finish, I would like to recognise, with appreciation, that our finance and agribusiness colleagues here today are also committed to providing essential leadership in helping to further secure the success of our industries into the future.

For the past three and a half years, I have chaired the Agricultural Finance Forum, which meets regularly in Canberra to discuss areas of interest between the finance and farm sectors. This has been a very useful forum to explore a variety of issues and gain a better understanding of each sector's needs and we have all gained a lot from it.

Conclusion

In concluding, the Government, like yourselves, is committed to fostering our rural businesses and ensuring they continue to be dynamic and self sufficient.

Partnerships between Governments, the financial sector and agribusinesses need to continue to be enhanced. The future of our industries depends on this. Conferences such as the one you have organised today helps promote the debate that will make this happen.

I welcome this and trust that today will bring forth a wealth of discussion about the new directions for our rural industries.

Thank you for listening and I would like to declare this Conference open.♦

4.3 Future Directions in Australian Agriculture

Mr Ian Donges, President, National Farmers Federation

Good morning and thank you very much for the invitation to speak to you today. Before I start, I just want you to know that although I am a farmer, I am NOT a whingeing farmer!

It always amazes me how many times I run into people who have the impression that it is all doom and gloom in agriculture. Australia's media contingent seems to have a long-term love affair with the phrase whingeing farmers. According to what you read, we always want more rain, less rain, higher prices, lower taxes, more disease compensation, fewer import risks, more Landcare assistance, less environmental damage. And on it goes…

But the reality is, farming in this nation is on the verge of a golden era. Much of the innovation and international success achieved in agriculture has been hidden by a minority of producers who struggle to see the way forward. Agriculture is no different to any other business sector, there are successes and failures.

Some blame the negativity associated with agriculture on hobby farmers, those who effortlessly grow a great crop of weeds. Others blame it on the visionless farmer who refuses to diversify or adapt his management practices to the challenges established through globalisation. I do not want to blame anyone. It is a fact that one third of Australian farmers have a negative income and it is natural that they will have a few gripes, especially dealing with the vagaries of nature. But we have to focus on the positives – on the remaining two thirds of producers and graziers who are having a go!

It is worth reflecting on the growth in agricultural exports. In 1988, exports were valued at $14 billion, compared to $24 billion in 1999-2000. About 70 per cent is now exported to an increasingly competitive and distorted world market. Wool is still Australia's top agricultural export, followed by wheat, beef and veal, and dairy products.

And when you look at the value of the wine industry, it gives you an indication of what can be achieved. Exports have just hit an amazing $1.6 billion and they are forecast to soar to $3 billion by 2005-06. This year, for the first time, sales of Australian wine in the UK have exceeded sales of French wine. To achieve this growth, there has been a huge shift away from the common agricultural philosophy: "My Dad did it this way. My grandfather did it this way. And I am going to do it the same way".

Farmers have realised they need to value-add, cut costs, increase yields, reduce costs, prevent the introduction of pests and diseases, embrace new technology, secure lucrative international markets and take advantage of biotechnology opportunities.

We are now exporting pasta to Italy, sake (rice wine) to Japan, rice to Asia, camels to the Middle-East, sparkling wine to France's champagne district, olive oil to Greece and tulips to Holland.

This long-awaited and renewed confidence in our rural industries can be attributed to several factors, such as vastly improved commodity prices, access to new markets and the value of exports due to the depressed Australian dollar.

The Australian pig industry is celebrating after seeing pork prices climb to a six-year high. Averages are reaching 240c/kg dressed for baconers and 270c/kg for pork.

Strong demand for live sheep exports is expected to keep sheep prices high through winter. Australian beef and sheepmeats are expected to have an even stronger influence on markets looking at substitutes for European product, in the wake of the recent devastating Foot and Mouth disease outbreak.

And returns for some horticultural produce are also soaring. Wine is one of the biggest success stories, but innovative citrus and apple producers are beating the odds.

While producers of cotton are failing to reap the benefits of the rural upturn, wool producers are finally smiling. And with demand for quality Australian wool from China expected to further increase and a wool shortage looming over the next two years.

The wool industry appears to at last be concentrating on market innovation, alliances, quality controls and escaping one of the toughest cycles in agri-history. However, there is no doubt that farmers deserve this long-awaited resurgence in their industries.

It has taken strength, determination, endurance, perseverance and a good business head for some to survive. And I think many Australian farmers deserve a bloody great pat on the back for what they have achieved.

But one word of warning to you all. Please do not think that all farmers are soon going to be driving around in new Range Rovers and buying holiday houses as a result of the recent upswing in the industry. There are fences to be mended, stock to be replaced, infrastructure to be upgraded and funds to be set aside for the next down turn. And there is a lot of work to be done on a national and international level, in terms of eliminating unfair trade barriers and ensuring quality of life for Australian farmers.

Before I talk about some of the hindrances to further agricultural development and enhanced international presence, I would like to comment on the broader economic environment in which farming takes place.

Since the start of 2001 the economic landscape has changed quite suddenly. The world economy has turned downwards, largely due to developments in the United States, while the Australian economy has also turned out to be weaker than forecast 12 months ago.

In the United States, the Federal Reserve started easing monetary policy soon after Christmas and this had implications for many countries, including Australia, when our Reserve Bank started easing interest rates from its first meeting this year.

As it turned out, when the December quarter national accounts were released in March we found that the Australian economy had contracted. No one predicted this. Even the Reserve Bank Governor, Ian Macfarlane has admitted, "we (meaning the Reserve Bank) did not foresee the extent of this weakness".

The contraction in the housing industry played a role and we felt the transitional effects of a once-in-a-generation structural change to the tax system. The negative growth figure for the December quarter appears to have knocked consumer confidence in the early part of this year and the economy has been crawling back in a slow recovery mode. But the decision to relax monetary policy in Australia was a good one and I believe there are signs that confidence is now returning the March quarter figures have confirmed this trend.

For the farming sector, the fall in the Australian dollar has boosted export revenues. In early March the dollar was at 52 cents and a month later it fell to 47 cents against the US dollar. Indeed, a floating exchange rate has, as one of its virtues, a capacity to automatically adjust to help a country deal with external factors.

It is no secret that Australian farmers hold the strong view that protectionism in agriculture in other parts of the world is a significant factor in commenting on the future growth of Australian agriculture.

I know I can speak on behalf of almost all Australian farmers when I say that I was incredibly disappointed that the American Farm Bureau and the US' National Farmers' Union decided to withdraw from the International Federation of Agricultural Producers and boycott the recent IFAP meeting hosted by the NFF in Canberra.

America has a strong competitive agriculture sector that can stand on its own two feet and the best way forward for the Americans is to engage with the rest of the world. It would be worrying indeed if the absence of the peak farm body in the United States at International forums is a sign that American farmers are looking inwards and sending signals of going it alone. The last thing we want to see is "Fortress America". We have to ensure the American farm organisations are a part of the international agenda. Earlier calls by the new US Farm Bureau President Bob Stallman to double subsidies were obviously extremely disappointing to Australian farmers.

If the US relaxed trade barriers, Australian woolgrowers would gain an extra $17 million per year. Sugar growers now export 85,000 tonnes to the US, compared to 800,000 tonnes in 1981. If we returned to the level of market access we had in 1981, each of Australia's 6500 sugar growers would reap an extra $50,000.

And we have estimated that the US' unfair and illegal trade barriers on Australian and New Zealand lamb have cost our industry at least $30 million since the tariffs were introduced on July 22, 1999. This issue is primarily about a trade principle.

There has been a lot of debate regarding farmers turning back the clock and rebuilding the tariff walls to "cure" their short-term problems. But the reality is, we have to ask ourselves: do we want to produce for a domestic market of 19 million or a global market of about six billion. The National Farmers' Federation has taken a leading role in pushing for competitive markets, less government

involvement and reduced protection in world agricultural trade. We are hoping the next round of World Trade Organisation trade negotiations – in Qatar in November – will deliver a new round of trade negotiations – especially after the Seattle debacle.

We have learned many lessons over the years but one that stands out is that there is no room for complacency in Australian agriculture. Quality assurance schemes are no longer just an asset, they are imperative. And it is supply chain management – from the paddock to the plate – that will ensure Australian farmers remain some of the most competitive in the world. No longer can farmers afford to wave goodbye to their products at the farmgate. We have all heard of seafood producers, flower growers and other perishable good producers that have worked their butts off to supply lucrative international markets with top-quality goods – only to find one link in the chain has failed. Only last week a Victorian fine wool producer was hit with a $300 bill after processors Chargeurs in Shanghai found black baling twine in the bale.

As for the future of Australian farming, I believe there is obviously a lot of potential ahead. However, to achieve this maximum benefit, it will require farmers, governments, financial institutions and other players to work hand-in-hand. We must recognise the enormous natural potential in Australia. Success will be our ability to compete internationally.

We are functioning in a global setting and although Australia is a relatively small producing country, we are an important international player. And we have to ensure we remain that way. Farmers have to continue to become more efficient and more globally focused. They have to operate as a business operation, rather than a family hobby. They have to attract investment into their enterprises, as well as their country towns. And to assist them in this process, governments and financial institutes have to better understand income fluctuations, the amount of money farmers invest in capital assets and the difficulties associated with handing a farm from one generation to the next.

We are confident that our agricultural industries will continue to prosper. We've led the world in trade reform and still managed to compete – and compete exceptionally well. And with further reform expected from our international competitors, there can only be greater opportunity and potential ahead for us.

Thank you again for the opportunity to join your conference and I look forward to much greater investment in our rural industries.♦

4.4 Evolution of the Australian Financial System

Dr T M Dwyer and Professor W P Hogan

When we talk about rural finance we traditionally have thought about banking. Hence it is worth starting with what banks are doing about redefining their role and what pressures are upon them. Since financial deregulation in the 1980s there has been a lot of "bank bashing" in some quarters. It is not our place on this occasion to go into perceived social obligations of banks but if one is to discuss the role of banks in financing industry, especially primary industries, it is probably wise to go back to history and start thinking about fundamentals. Debates on the role of banks need to move on from assertions and look at what banks and other financial institutions have been able to do in the past, what they can do now and what they can be expected to do in the future. Just as importantly we

need to ask what they might not be able to do, constrained as they are by the absolute need to keep depositors' money safe.

In his recent survey article on the future of banking Hogan (1999) starts by reminding us what banking is about. Essentially banking is about linking together parts of the real economy, bringing borrowers and lenders together, moving surplus capital to deficit sectors that need it.

In carrying out this function, banks are starting to realise that their unique position really is as information processors and dealing with asymmetric information. The implications of information asymmetry become very profound because in the real world borrowers and seekers of credit have an essential advantage over lenders. They know more about their businesses than the banks, or investors or anyone else does. So the problem arises of adverse selection. The people who want the banks' (or their depositors') money most, the people who are willing to do the most to get it, may well be borrowers a prudent lender would not necessarily wish to lend to. The role of banks in carrying out credit rationing, or credit selection, is basically to pick out the best risk-return ratio. That is why, of course, banks have evolved arbitrary credit rules and through statistical experience they have decided that certain filter rules are necessary to sort out the good and the bad risks. It may seem "rough justice" to an exceptional prospective borrower of outstanding character but, like all decision makers faced with mass administrative decision making, banks have to evolve rules of thumb – after all, they are responsible for the safety of other people's money.

Accordingly, Hogan suggests that the role of banks has really been to thwart adverse selection arising out of the asymmetric information problem: by analysing all the financial conditions and market prospects of all borrowers banks can generally get rules as to how the borrowers should be performing.

From a borrower's point of view, a sense of scrutiny by a lending bank may feel uncomfortable at times. They may feel it is a bit like the Tax Office checking their tax returns against statistical ratios and then following up with an audit to check whether the business is performing all right, or according to what they think the business should be doing. Perhaps this partly explains why people do not always like banks, if they think of them as managing ongoing audits of their customers. But, unlike the case of Tax Office scrutiny, depositors and borrowers do get a real benefit from this sifting process by banks. Depositors can trust that their money will be kept safe while for borrowers who take the trouble to manage their businesses properly and keep their engagements there is the promise of credit when required for business development. At the end of the day, borrowers recognise that there is a quid pro quo. If you want other people's money through the banks then banks will naturally try to carry out the task of making sure the money is recoverable and not lost. There have been notorious cases in the past where some banks in Australia and overseas have not been as careful in making corporate loans as they might have been and have been roundly criticised for the resulting losses. Bad loans are inevitable in banking but part of the art of banking is to minimise the risk by careful screening of borrowers at the outset.

Once a loan is made the point then shifts from asymmetric information about who is to get the credit to a question of moral hazard: once a borrower, entity or individual, has the money advanced, they may not perform up to standard or meet the conditions of the contract. There are many things that cannot be fully negotiated and dealt with in a loan contract: good faith is required in addition. No loan contract can fully deal, for example, with the unemployment or disability of the borrower. In this state of uncertainty, other precautions, such as security or insurance requirements, have to be put in place to take account of foreseeable but not always easily managed contingencies such as death, disability, divorce or insolvency of the borrower.

The difference in information between providers and seekers of funds is a feature both of direct credit markets, as with bank lending, but also of securities markets. The only difference between them is little borrowers, unlike large companies, cannot afford to pay a Moody's rating agency or Standard and Poors to go over their businesses to check their credit worthiness for a public issue. Small

borrowers cannot afford the cost of a public prospectus so smaller entities such as smaller agribusinesses must rely on banks for access to funding. They must therefore rely on banks to carry out the credit and security checks to certify their creditworthiness.

This historic pattern of direct credit provision by banks to primary producers has come indirectly under pressure from deregulation. In the past, historically over the Western World and Japan, there were two polar extremes of banking. At the one extreme there was the United States with a system of small regional banks, some large money centre banks, but with a huge amount of capital being raised by the capital markets and traded as securities which are graded by investment institutions and credit rating agencies such as Moody's and on-sold to investors by Wall Street. At the other extreme you had the German banking system which some argued in the 1960s and 70s should be the model for Australia. These banks were "all finance" houses – they did everything. They not only lent to, but they also took up equity interests in, and often exercised control over, large industrial organisations. Thus they could influence and direct the investment policies of major sectors of the economy, something which was attractive to those who felt Australia needed development finance institutions. Fifteen or twenty years ago one often heard that the trouble with Australian banking was its excessive conservatism, that Australia did not have entrepreneurial banks, it did not have banks that would actually grow with the business – put the money in, be patient and fund industrial development like German banks. But note that all this was largely occurring away from the scrutiny of public markets. This was a very significant aspect of the German banking model.

The British banking tradition, which Australia has naturally inherited as with so many valuable traditions, lies between the Americans and the German model. The British tradition was national branch banking, and very few small community banks, at least not since the consolidations of the nineteenth century country banks. British and Australian banks did not crash in the Depression although there were a couple of forced mergers. With large bank branch networks Australia did not experience the catastrophic closure of thousands of small banks which occurred in the United States in the 1930s.

But on the other hand the British banking tradition is pretty hard-nosed. We are lenders is the creed of the British bankers - we are not equity investors. Our duty is first and last to honour the cheques of depositors. As Hogan (1999, p 427) puts it, the banks' ultimate *sine qua non* is "to preserve the stored value of obligations to customers". No bank can afford to fail. After watching the recent collapse of HIH Insurance, Australians have a renewed realisation of how devastating it is when a financial institution fails. The collapse of a financial institution sets off ripple effects across the whole economy and creates chaos. We are perhaps more grateful if our banks attempt less but continue always to honour our withdrawals.

Now there are six basic functions which Hogan (1999) observes as being defined to be functions that banks carry out.

First of all there is the clearing and settlements process, the "payments system". This is now ostensibly under the control of the Reserve Bank of Australia and some financial institutions such as credit unions have sought admission. However, with the official imposition of the Real Time Gross Settlements (RTGS) for large transactions, the four major banks have established significant liquidity support provisions as have other members of the Australian Payments Association. Thus the banks retain their historic role in payments commitments.

The second function which one thinks of banks doing is pooling and divisibility. What this means is bringing in a flow of funds, collecting small amounts of money, converting them into large amounts to be lent out, and then dividing up the proceeds from them. Pooling and divisibility is more familiar in terms of intermediation as being the main function of banks. When people think of banks they think of them as institutions that collect funds and lend them out.

But pooling and divisibility are not unique to banks. For example, weekly premium life assurance used to be called "collector policies". These days securitisation of part of banks' asset portfolios, such as occurs with residential mortgages, transfers the pooling and divisibility function to non-bank institutions. For example, managing a superannuation fund with funds flowing in to be invested out is akin to contractual deposits with banks. The buying of a securitised portfolio is akin to the divisibility function of banks. Pooling and divisibility are not functions unique to banks.

The next function which banks are supposed to carry out is maintaining the real level of the economy by keeping the system running. One can think of finance as in itself not very important. Though banking and finance have a wonderfully glorious and romantic image in many people's minds, the truth of the matter is that finance is only the oil in the engine. The real economy is what generates income and growth. No one eats green pieces of paper or plastic – it is actually real things like food, clothing and shelter that people want from participation in the economic system of exchange. However, while finance may only be like oil in the engine, that oil in the engine is crucially important. If the oil runs out, the engine freezes up and the whole system – the real economy - crashes. Hence the interest of so many people in financial panics and crashes.

The next identified function of banks is risk management. Risk management occurs with interest rate risk, borrowing short while lending long, arbitraging along the yield curve and so on. But this function of banks is now also being outsourced. With derivatives trading in financial futures on public markets such as the Chicago Mercantile Exchange, banks no longer have to absorb some of these risks – and there are competitors. A large corporation does not necessarily have to go to a bank to buy a forward foreign exchange contract now: its treasury can go and buy it from the New York or the Chicago Mercantile Exchange, or in London or Singapore or Sydney.

So one then comes down to another function of banks and that is managing information. That brings us back to the start. Transactions in financial instruments are at the core of banking and financial markets, whether they be through intermediation fostered by the banks and similar deposit taking institutions or whether they be through direct financing undertaken through public equity and debt markets.

This is where one gets to the nub of it. The larger market participants may turn to direct financing through issue of equity or debt on securities markets. Their size allows a range of brokers, investment houses and funds managers to devote attention to the quality of the offerings. The extraction of thorough and accurate information is secured by ratings agencies whose activities are financed by the listed companies in order to ensure an informed market about each of them.

But smaller entities lack the size which would warrant their listing. They are unable to issue securities that would be traded with the frequency or the liquidity that investment institutions demand. No superannuation fund and no manager of a managed fund is interested in going out and buying a mortgage from a homeowner mortgagee nor are they interested in buying into a little unlisted private company where there may be squabbles between family members. There have been examples of family disputes even in large private companies such as Transfield and external investors have not got the capacity or expertise to get involved in that level of detail or messiness. External investors, especially fiduciaries, are simply not interested in buying into potential lawsuits as minority equity holders in closely-held companies, trusts or partnerships.

So, in a sense, banks and financial institutions act as intermediaries in getting through that funding reluctance on the part of investors. The last function of banks is the one of completion; namely, banks make sure that the transmission of funds and the settlement of transactions are carried out.

The point is that many of these functions of banks could be taken over by others – cash management trusts can be used, as Macquarie has shown, as proxies for bank deposits. That is how they evolved under Regulation Q in the United States. Pension funds take in large long term savings and they can act as intermediaries. Credit and interest rate risk can be dealt with through the futures and insurance

markets. But the one thing that banks still retain is the ability to monitor information and deal with the asymmetric information problem.

So in a way non-bank financial institutions and non-bank financial markets cannot be complete substitutes of banks as intermediaries. If one thinks about it, banks have a key role to play even if they are no longer holding assets and liabilities on their books. They often certify the origination of the securities no longer on their balance sheets or even arising outside them. One sees that the acid test for banks is their ultimate ability to maintain their solvency and pay out their borrowers and they can trade on that function in more ways than simply borrowing and lending money – for example, bank endorsed bills of exchange have been part of the business of banking for centuries.

When one sees preservation of solvency as the key test of banking and one sees managing information as the means of ensuring that outcome, one starts to appreciate why the Japanese banks' bad debt problems are such a disaster. The problem loans which seem to get worse and worse are showing the dangers of banks becoming "all finance" houses and all things to all men (and women) as it were. Once bad loans call into question the solvency of banks, a banking system can become paralysed and, in turn, the real economy can also become paralysed. It is like oil freezing up the engine because there isn't enough of it and it is no longer doing its job.

Turning then from banks as institutions and realising they still have a role in dealing with this asymmetric information problem, one should put these functions into the context of how the whole financial sector is changing in Australia. Battolino (2000) observes that what has happened in Australia since deregulation is that there has been a tendency for disintermediation – for borrowers and lenders to bypass the major intermediaries such as banks. Banks have had pressure on their margins and there has been increased efficiency in financial intermediation - bank margins actually have shrunk.

Several things have contributed to disintermediation. The capital requirements for banking have been increased. Each loan now costs a bank more of its own capital to hold than it did in the 1960s. Superannuation has come under much greater regulation and there have been compulsory contributions to superannuation imposed by law. So superannuation assets have grown faster than bank deposits. Superannuation funds do not put their money back into bank deposits. They are expected to invest them to maximise the long term yield. With bank deposits shrinking relative to the rest of the financial sector and superannuation assets rising, one can see there could be difficulty in making funds available to the rural sector as freely and on the same scale as in the past when banks were the main sources of funds for the rural sector.

The problem perhaps is similar to, but less severe than, the problem which the American thrift institutions encountered with interest rate deregulation in the 1970s and 80s. As interest rates were allowed to float in the United States and Regulation Q was relaxed, the flow of funds into housing institutions in American dried up. What happened was that Wall Street had to spend a lot of time and effort thinking about securitising home mortgages in order to find another way for loanable funds to flow back to that sector of the economy. Perhaps problems in the rural sector will emerge later, but if banks are less significant in the flow of funds and the rural sector used to rely primarily on banks for the flow of external finance, then the rural sector may have to think about how to get into the securitisation game. This means how to make itself attractive to new forms of institutional financing through superannuation funds and managed funds.

In terms of international developments in financial markets, securitization has spread from America to Europe. With the introduction of the euro, pension funds and life assurance companies can now hold their assets across all countries in the euro zone. That is one advantage of the euro – it may be a weak currency but for a bank or insurance company or pension fund, to have euro denominated assets across four or five economies is much better than being trapped in one national economy. Thus there seems to be occurring a move away from one-to-one financial intermediation where the bank raises the money, privately assesses the client and that information remains private. The banks are now

moving to the stage where they become originators of securities; they make the loans and then bundle them up into securities to release their capital and liquefy their balance sheets. They act as certifiers of the quality of the securities they are originating, but there are no residual guarantees.

That has been the US experience and it seems to be emerging as the European experience. Australia may be an island, but in terms of world capital flows Australians know very well Australia is not a financial island. These trends apply in Australia. More and more money is in the hands of people who look for tradeable, liquid, listed securities or proxies for them. A continuation of disintermediation away from banks and towards direct holdings by mutual funds, pension funds and even small investors themselves, is inevitable.

So the role of banks and the financial sector is changing - more and more people are directly holding assets but what they are relying on financial intermediaries to do is to originate those assets for them. For example Ord Minnett offers a fund which contains a provision whereby Westpac guarantees the eventual return of capital invested at maturity. That guarantee is matched by a cash collateral supplied by the fund. Nonetheless there remains a contingent liability for Westpac even though the fund itself has no connection to the Westpac balance sheet. Westpac's guarantee of the return of capital on maturity is an indication of the fund being a reputable offering, that it is something one might reasonably invest in and take one's chances knowing that fraud or moral hazard or exploitation of asymmetric information is not going to be such a problem for you compared to investing in such a fund at random over the Internet.

The trend has been quite clear in the United States – there has been a huge move from bank deposits to direct credit and debt markets. Europe is following. What Australian primary producing industries need to think about is what this means for rural finance. Bank finance will always be important and banks will find new ways to participate in financing but they cannot operate as perfect substitutes for access to broader credit and equity markets. The portents from the evolution of finance for Australians are about the need to think, in all its finance-seeking sectors, not just agriculture, but particularly agriculture, about tapping into the new public securities paradigm for global financing. ♦

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4.5 Discussion

Chair: Mr Jim Gale, Executive Director, CEDA.

Question: (*from the Chair*): I guess a quick two-pronged question that I could put to Dr Dwyer deputising for Professor Hogan. You talked about the Treasury view of the world and we should not dismiss it out of hand – I mean markets are generally efficient – is there something happening in agriculture? I mean if there's problems with return on equity in agriculture shouldn't something be

adjusting the asset side of the equation, in other words to increase that return on equity over time? And just a quick second question – you talked about these global trends and a move towards disintermediation, and of course banks have to respond to that, and they have done that by looking for a higher return on equity, closing down branch structures to get more efficient, looking for a short term focus themselves, does that indicate that agriculture really is being left behind and that if something's going to happen it is not going to happen on the institutional side of the equation, that farmers themselves might have to come up with the solution?

Dr Dwyer: If I could make a couple of comments, firstly on the Treasury view of the world – I think there is a lot of merit in the Treasury view of the world, particularly because ill advised intervention often does more harm than good and we've seen examples of white elephants and so on. But on the other hand I think the Treasury view of the world in the sense of 'do nothing and the markets will work' is also inadequate because it forgets that markets do not exist in a vacuum, they operate in an existing set of legal institutions.

For a market to work you have to check out what that existing set of regulations is. For example before the US government could solve the problem of the failed thrifts in the 1980s, two US statutory corporations had to get involved in changing the law to allow their securities to be traded across State borders in the United States. The United States did not have a national housing market for mortgages before the 1970s. It was the Fannie Mae corporation as a US government agency that enabled investors across State borders to satisfy local State investment restrictions on insurance companies and pension funds. Without that ability to trade across State borders there wouldn't have been a market.

Secondly they had to change the tax law in the US: it took three years for Solomon Smith Barney to fight the US Treasury but finally the US Treasury agreed that the tax law was an impediment to creating a national market. And of course there was a political impetus because the US Congress was faced with a problem of bailing out billions and billions of dollars of insolvent housing loan institutions, so that is actually what triggered the process.

So I think the Treasury view of the world has a point, but basically the first thing to do is go and examine your existing institutions and that is what I hope we will do here today – are there things which are preventing market from working? For example – I can think of one example (and perhaps Senator Troeth will be quick to avoid commenting on this!) but the exemption of the family home from the assets test is clearly a form of government intervention designed to subsidise people remaining in uneconomic farmlets, because why would you trade an assets test free asset and sell out and be means tested on an investment portfolio when, if you like the rural lifestyle and you are only semi-farming, why bother? Now there are all sorts of little regulatory distortions like that which exist.

Turning to your second question, the global pressure on banks and what farmers can do, I think it is interesting to realise that farmers are not powerless, they are market participants – they do have farming organisations. When you think about the evolution of the Chicago Futures Exchange and the Mercantile Exchange and how futures contracts arose from farmers and merchants getting together and gradually there was a standarisation of contracts, and as the contracts got standardised the quality of the product got certified, then you could have trading. Actually that is another point that I should have mentioned (and which Warren Hogan makes). It is that banks are increasingly driving towards standardised mortgages for residential mortgages, just like the Law Society and the Real Estate Institute standard conveyancing contract for sale of land. The more you can standardise your legal documentation, the more you can standardise your contracts, the more you can trade, the more you can bring in secondary investors such as pension funds who are interested in liquid assets. They are not interested in individual loans to this or that person, they are interested in just 'how much do I pay out, how much is it worth day to day, how much can I sell it for, what's the yield to maturity?'

Question: *Terry Larkin, J T Larkin & Associates*: I was wanting to ask Ian Donges or perhaps Senator Troeth a question. Can you say a little more about the feel – the business "feel" in agriculture now, say, compared to five years ago? Do you see a substantial uplift in the business outlook, and in optimism, and I suppose in the overall outlook for the rural sector? Is that being reflected in the farm assets values and also do you see the supply of young farm managers - farm business people - improving significantly compared to five or ten years ago? My idea is to get some "feel" from a Sydney perspective, since the Sydney business community, I suppose, has largely ignored agriculture in recent years. Do you see a new era coming forward?

Mr Donges: It is a question I think that is probably on a lot of peoples' lips about the confidence that is around, is it real, and so on. My view is that there is a much stronger confidence than five years ago for the reasons that I gave before. We have seen considerable improvement in commodity prices; we have seen a considerable uptake in new technologies; and, farmers have by and large - the successful farmers - have continued to keep their productivity improvements going at a very good rate and that is reflected in the growth of exports and the growth in the volume of production.

The flow of young farmers and the young people coming into agriculture are a worry. From my point of view it is a worry. We have had this lack of confidence projected to the wider community about future opportunities in agriculture. There are some great exceptions to that but overall I would like to see agriculture being projected as one of the industries, of course, for future careers, for bright young people to be involved in. That is also reflected in the problems of inter-generational transfer of farms where you have got still, unfortunately - and I am probably nearly one of them - farmers who are reluctant to move their operations back to the next generation. But there are many ways around these problems. I do not think we should be too disillusioned by them. But overall, just look at the last eighteen months – two years, with high commodity prices and much better terms of trade for many farmers across Australia. Their confidence has risen and so has their asset values. Many farms have seen a considerable increase in their asset values in the last two years as a result of that better trading environment.

Senator Troeth: Certainly there is money coming into agriculture into what I would call new industries. Obviously the wine industry is a great example and horticulture, which I deal with, has much more investment in it and is now ranked third in terms of output behind meat and grains. So, although a collection of small industries, it is now Australia's third largest agricultural industry.

There have also been geographic movements and land change. For instance in my own home State of Victoria you have had traditionally intensive horticultural areas in Werribee which is now an outer suburb of Melbourne and horticulturists there are selling up, buying land along the Murray River and putting huge 4,000 acre type carrot and capsicum farms along the Murray River. In turn, along the Murray River land use has tended to change from predominantly citrus and dried fruits to wine grapes, but also to intensive horticultural use. There are other intensive horticultural areas going in, in hitherto unused parts of Australia, such as around Hillston.

The balancing side of that is, of course, the availability of water and that is a debate that is yet to come, so some of those environmental aspects have to be balanced against that intensive production. Very briefly, the dairy deregulation changes will, I believe, see a shake out in the dairy industry, some farmers moving out of it, but other farmers deciding to stay and expand their holding to the extent that Ian Donges mentioned in his speech. We also have a farmer in Victoria who is milking cows totally by computer and laser scanning. He does not need to be in the dairy and the cows are moving into, through and out of the dairy totally by remote control, which will bring changes to the dairy industry – it is true – it is strange but true. This will bring huge changes to the dairy industry I believe – that sort of technology.

So with regard to the young farmers I would also echo Ian Donges' sentiments there – the oft quoted average age of Australian farmers is sometimes said to be 58, we would all like that to get better.

There are programs around both my own department who are trying to bring forward teams of rural leaders, the National Farmers' Federation have sponsored a couple of round tables of 100 under 35s who are leaders in the industry. There's an Australian Rural Leadership program, but we all need to be very conscious of encouraging those younger or tertiary educated young people who want to go into farming. That is one of the things we are going to have to grapple with in the future with the view to providing them with finance.♦

4.6 Problems and Challenges of Rural Finance

Mr Bruce Brown, shortly to become General Manager, Strategy, Queensland Cotton Ltd.

Introduction

One of the key problems confronting Australian agriculture and providers of financial services to the sector is the increasing polarisation of the financial objectives and performance of farm businesses across all industries.

This paper briefly analysis's these trends, comments on the performance of rural sector lenders and focuses on some key issues which will have an important impact on future rural capital market trends and the deliverables of the financial institutions servicing the sector.

Profitability Trends in the Rural Sector

The relationship between productivity growth, farm size and individual farm business unit level profitability is now well established.

Larger farm units have achieved significant productivity gains together with those involved in the cropping and horticultural industries. By comparison, the livestock sector has performed poorly. (Table 1 & Figure 1)

Table 1

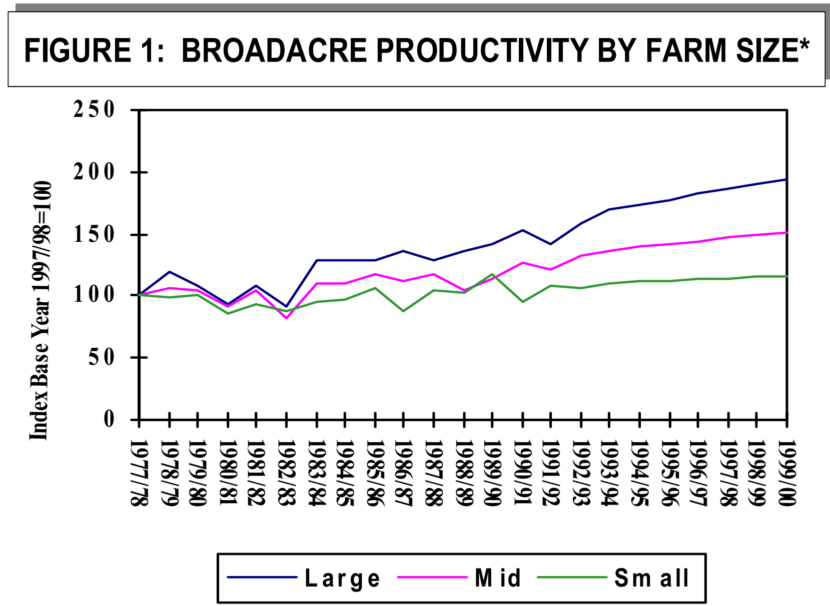
Australian Broadacre & Dairy Industry Productivity Growth

(Annual Rate of Change, 1977/78 to 1998)

	Productivity %
Zone	
Pastoral	2.7
Wheat – Sheep	3.2
High Rainfall	1.0
Industry	
Cropping	3.6
Mixed Crops – Livestock	2.6
Sheep	0.6
Beef	2.1
Sheep – Beef	1.4
Dairy*	1.6

* Dairy data 1978/79 to 1996/97

Source: ABARE



*** The split of broadacre farms among the three groups is based on the estimated 33.3 and 66.6 percentiles of dry sheep equivalents in each year.**
Source: ABARE

The significant number of farm businesses that have negative cash incomes best illustrates the dualism within the farm sector. After allowance for depreciation, changes in trading stocks and the imputed value of operator labour a significantly larger number have negative profitability. (Table 2)

Table 2
Profitability Trends – Broadacre Industries
(1997/98 – 1999/00)

	1997/98	1998/99 p	1999/00 s
All Broadacre Industries			
Negative Farm Cash Income (%)	24	28	28
Negative Farm Business Profit (%)	65	71	70
Sheep - Beef			
Negative Farm Cash Income (%)	31	33	39
Negative Farm Business Profit (%)	77	79	75
Wheat & Other Crops			
Negative Farm Cash Income (%)	12	16	22
Negative Farm Business Profit (%)	41	56	56

Source ABARE *Farm Surveys*
p – Preliminary estimates: s – Provisional estimates

The profitability dilemma confronting the farm sector is best summed up by a RIRDC report produced by Australasian Agribusiness Services in 1997 which succinctly states that:

- 80% of broadacre farm businesses generate 48.2% of agricultural output and reduce aggregate industry profitability by 49%; and

- the remaining 20% generated 52% of output and virtually all of the profits (Figure 2)

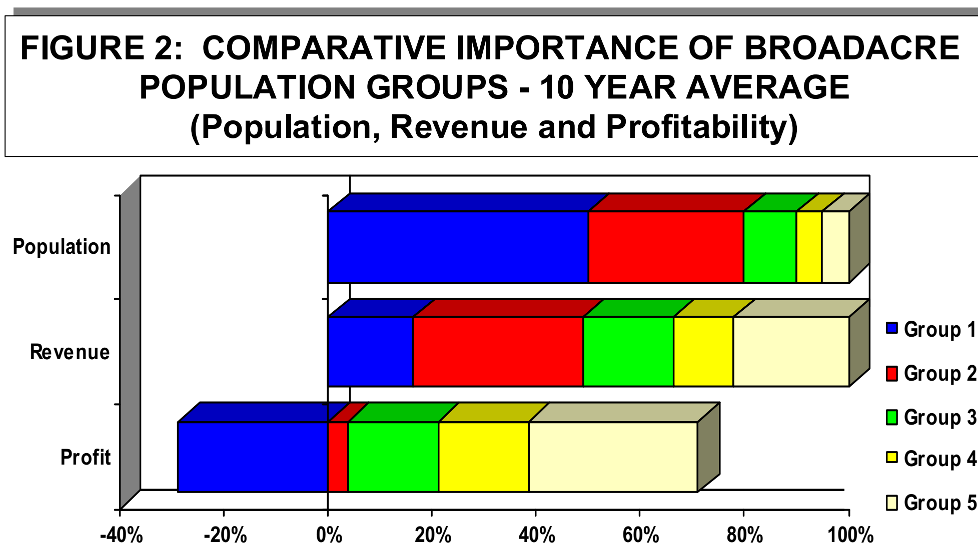


FIGURE 2: COMPARATIVE IMPORTANCE OF BROADACRE POPULATION GROUPS - 10 YEAR AVERAGE (Population, Revenue and Profitability)

Establishments grouped according to total size of cash returns. Group 1 = the bottom 50%, Group 2 = the next 30%, Group 3 = the next 10%, Group 4 = the next 5%, Group 5 = the top 5 %.

Source: Australasian Agribusiness Services, "Financial Performance of Broadacre Australian Agriculture', Feb., 1997.

Farm Debt and Finance Trends

Farm institutional debt continues to rise (up 26% over the 5 years to June 2000) and an increasing proportion of farm business capital expansion is being funded via debt rather than retained profits.

Average farm business equity levels have broadly held overtime (80% - 90% depending on industry) and it is increasingly apparent that debt is being concentrated in the 'top quartile' based on debt/equity ratios since here the profitability exists to support debt servicing.

The Major Trading Banks (MTBs) have over time developed a more dominant share of farm institutional debt given the declining role of state banks and government lending and despite the prominence given to developments in community banking.

Whether the MTBs retain their dominant position in rural finance markets depends on their level of participation in the growth of what for want of a better term can be classified as secondary markets. Non-traditional lenders such as input suppliers (eg fertiliser, farm machinery, merchandising, etc) have grown their lending businesses in part by private placement/securitisation of loan portfolios. In some ways, the squeeze on operating margins in input supply industries has forced some of these entities to seek out other revenue streams and/or underpin sales with a competitive finance package. None of this should be surprising since to my knowledge the first securitisation of a farm sector seasonal loan portfolio took place in 1989.

The reasons for private placement/securitisation are numerous and include liquidity and risk management, expanded lending activity, etc. With these comments in mind, it is easy to envisage the growth of strategic alliances, joint ventures, etc between input suppliers and financial institutions which may or may not involve the MTBs.

Branch consolidation continues unabated and this appears not to have impacted on the intermediation of debt capital to those farm businesses whose profitability profiles fits lending parameters.

The level of human resources with agribusiness industry skills utilised by the MTBs has increased over time. However, in essence this is not true of all the major players.

Rural loan portfolio management has substantially improved over time and we have seen the development of credit rating/scoring systems, which I will discuss later in this paper.

Product mix options have widened considerably given the increased sophistication of the financial and risk management skills especially in the 'top quartile' farm businesses. Additionally, the level of competition for 'profitable' lending business has also intensified considerably during the 1990s.

Overview Commentary

It is not surprising that given the polarisation in the financial performance of the farm sector that lenders have analysed in detail the revenues generated from clients and aligned both their product mix and level of servicing accordingly. At the 'bottom end' of the farm sector, where the finance needs are both simple and low volume, servicing via generic lending products and centralised telephone service centres is the only way lenders can deliver services profitability. At the other end, the product mix options provided are more sophisticated and are supported by personalised account management. In essence, the dual service propositions developed by the major rural lenders has predominantly been a derivative of the increased 'dualism' which has developed across the farm sector.

Future Issues/Developments

Given the nature of this paper I cannot comment in any depth on the plethora of future issues/trends that will occur in the provision of financial services to the rural sector. Instead, I have decided to concentrate on three major subjects which I believe are where major improvements can be made and where the impacts will be significant.

Valuation Methodology

Rural sector finance providers have the opportunity to pressure the valuation profession to significantly revamp their valuation methodology as it pertains to farm businesses and adopt practices which value land on the basis of an EBIT (profit before interest and tax) multiplier and not solely on the normal 'summation approach' which involves historic land sales analysis.

In making the above comments I am aware of the legal/statutory framework which impacts on valuation practices. Additionally, it is important to draw the distinction between viable and non-viable farm businesses since any economic analysis of the latter's performance is largely irrelevant. However, in the case of profitable farm units there will be a relationship between site value and the ability/capacity to generate profit.

With some exceptions, many within the rural valuation community have long overlooked the issue of investment yield on rural assets. This is despite the fact that it is a fundamental criterion in assessing the value of other income generating property in the commercial, industrial and investment residential sectors. This may have also constrained the inflow of capital into the farm sector.

During the 1990s a raft of successful litigation developed against valuers that conducted valuations based solely on the summation approach (land and fixed improvements). In essence, they failed to validate their approach by utilising economic performance benchmarks or databases available to them. In particular, my comments relate to large scale and/or highly specialised agribusiness activities.

The conundrum for lenders is that using EBIT methodology may well result in changes in valuations that will provide for lower loan/security ratios. Notwithstanding this potential immediate impact, the advantages for the sector would be significant. To this end, I believe that joint discussions between the banking and rural valuation professions should result in the wider utilisation of financial performance figures in the valuation process and provide for a more professional end result.

Increased Dependence on Quantitative Decision Models

Financial institutions are increasingly utilising quantitative decision tools to manage the loan approval/rejection process and in loan portfolio balancing decisions. The benefits are clearly cost effectiveness and the application of standard criteria to both credit and loan portfolio decision making.

In the case of credit scoring models, most involve the evaluation of historic and current financial ratios. They are very effective where the customers business and financial profiles fit neatly within the decision parameters of the quantitative model used. However, they can create difficulties for borrowers with either profiles or lending proposals that do not fit within the parameters of the models used. This is especially so in the case of farm business expansion either at or past the farm gate since these proposals frequently raise complex and non-routine questions that the lender must analyse.

The issue is not the use of credit decision models, more where there is a dependence on these models to analyse complex or 'one-off' loan proposals. Doubtless, credit scoring models are here to stay, however the challenge for rural sector lenders is to develop models, which provide for increased flexibility given the volatility of farm financial performance. Additionally, such models must be utilised in an environment where the capacity exists to transfer the decision making to experienced lenders when customer profiles do not fit model criteria.

Equity Capital Access

It would be remiss of me in a paper exploring future finance trends not to comment on equity capital since it is important in securing access to debt capital. Access to equity capital is frequently overlooked in any discussion on rural capital markets. However, it can be an important source of capital for farm entrepreneurs expanding into downstream processing, marketing, etc.

Equity capital covers the spectrum from mezzanine financing, including products ranging from subordinated debt to more traditional venture capital investments, to pure shareholder equity.

A small number of existing venture capital/investment vehicles have targeted agribusiness and/or are willing to investigate projects in this field. However, they would appear to be little known in rural and regional Australia and even less is known about their *modus operandi*.

There is little doubt that the farming sector (with some notable exceptions) has in expanding either at or past the farm gate relied predominantly on debt finance as a source of capital given the difficulties of securing access to equity capital outside immediate family members. The reasons for the latter problem whilst numerous generally fall into the following 6 broad categories:

- The size of individual projects is small and in the majority of cases less than $5m.
- Project returns are generally lower than the threshold rates of return sought by the providers of equity capital (ie greater than 20 per cent per annum).
- The high information cost associated with identifying and evaluating small projects in diverse industries/locations.

- Many primary producers are loath to involve themselves in projects, which involve alliances, partnerships, joint ventures, etc, fearing a loss of control. This fear and in some cases hostility is not conducive to raising equity capital since the providers will seldom venture into these environments.

- There is little broad knowledge in non-rural communities of rural investment opportunities and press coverage tends to highlight negative aspects of farm financial performance.

- Farming and related downstream processing may be perceived not to have the "high tech" characteristics necessary to attract venture capital.

Generally access to equity capital is restricted to family sources and individuals on an ad hoc basis. Access to equity capital is relatively unorganised and whilst very significant capital exists in the farming sector it is 'tied up' in fixed assets and is difficult to release given the high equity ratios resulting from relatively low debt servicing capacity. The intergenerational transfer of farm businesses can also result in the flight of capital out of agriculture and its frequent replacement with debt finance.

One of the other problems in attracting equity capital into rural businesses is that the owner(s) tend to focus on long term business development rather than creating a business for sale in the short term. Additionally, owners also focus on passing on businesses to family members and have a different perspective on business growth than equity investors. Subsequently they are less likely to be attractive targets for equity investors. Also exit strategies for investors are frequently less clear than in other markets.

Whilst a variety of programs sponsored by State an/or Federal governments have focused on sustainability and improving the business and risk management skills of primary producers, little attention has been focused on how to access equity capital.

In looking into the future a number of things can be done to improve the farm sector's access to equity capital and these include:

- Regional development bodies could form stronger partnerships with firstly State and secondly Federal governments to create the linkages to access equity capital and support/education programs.

- Regionally based education institutions could be harnessed to provide technical and managerial assistance to entrepreneurs via business incubation programs.

- State based primary producer bodies could assist their members in developing networks within the investment community.

- More generally there appears to be a need for more investment brokers or intermediaries with an agribusiness background to bring together entrepreneurs and investors.

In making the above observations, it must be noted that the responsibility for obtaining capital rests with entrepreneurs, as this is a fundamental business skill.

Concluding Comments

Whilst it is difficult to support arguments that there has been market failure in the provision of debt capital to the rural sector, policy makers could be well serviced in reviewing the difficulties the sector has in accessing equity capital.

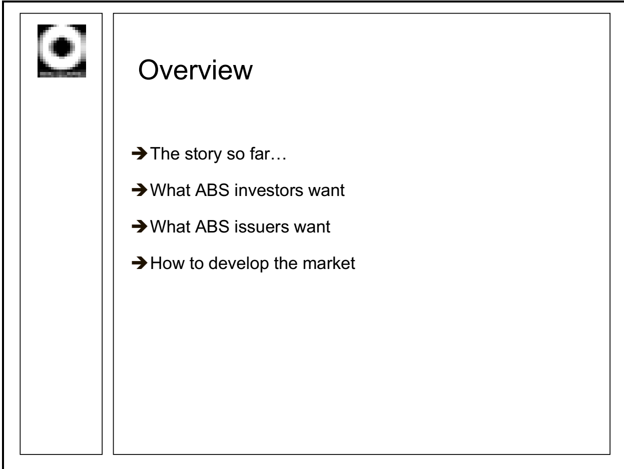
Technology in its myriad forms has been a powerful force in reshaping Australian agriculture providing for productivity increases frequently higher than in the rest of the economy. The Chairman of the US Federal Reserve, Alan Greenspan, has argued that technology, especially information technology has propelled a process of 'creative destruction' – replacing old businesses with the new, reducing the cost of doing business, altering the mix of goods and services and shifting the location of economic activity. None of this is new to Australian agriculture.

To enjoy the rewards of the information age the rural sector must have access to financial institutions and capital markets that can service farm business expansion (either at or past the farm gate), support new businesses and innovative practices. The increased competition which has characterised farm sector lending during the 1990s and the new technologies will continue to be the catalyst for product mix innovation and the delivery of services to those businesses in the sector capable of utilising them.♦

4.7 Securitisation of Australian Agriculture: How can it be advanced?

Mr Robert Harris, Division Director, Debt Markets, Macquarie Bank Limited.

I specialise in asset backed securities and credit derivatives. I want to give you some thoughts on my view as a practitioner in capital markets in Australia on how to securitize agribusiness and some of the issues we are seeing in the agribusiness sector.



What I want to do is to look at the story so far, at what has been happening in the market, both domestically and offshore, and then really to try and consider both sides of the investment issue, what investors are looking for in the asset backed capital markets, what their motivations are, what the potential issuers of securities in the asset backed markets are seeking to do and why, and hopefully by putting these two sides together, we can reach some conclusions on how to develop the market better.

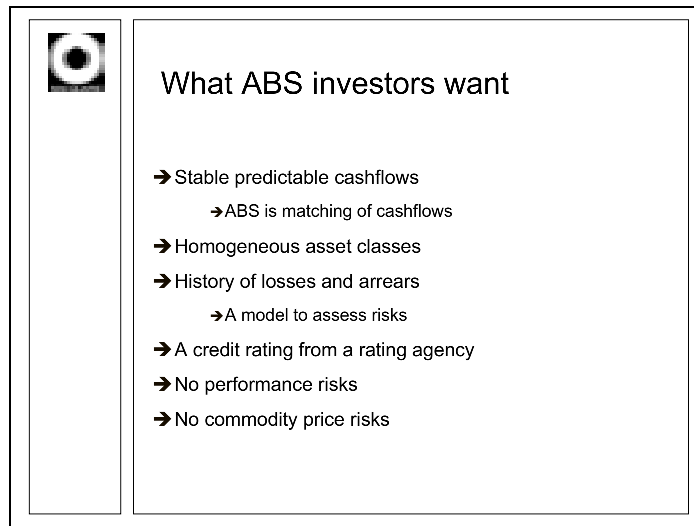
The story so far, unfortunately, is not a terribly optimistic one. We have seen really, globally, very little securitisation of agribusiness assets, of rural assets.

It is interesting how Bruce Brown was talking about the first seasonal loan style securitisation occurring back in 1989. That is about the same time as the residential mortgage backed market kicked off in Australia or even in fact outside in the US, and yet we have seen the global market for residential mortgage backed securities is really a phenomenally large market. Contrast that to the global market for rural securitisation which, by comparison, is absolutely nothing. So what have we seen? There has been some securitisation of trade receivables but of course one could argue that trade receivables are not really rural credit. Credit receivables typically have been for the corporate market - corporate credit - not for a rural commodity, so you really get bracketed in industrial trade receivables, industrial credit. So I think we can probably discount those as being true securitisation of credit.

There have been a few commodity trade receivables style transactions that have been done. We have seen some seasonal loan style transactions with crop liens, things like that and these have tended to be vendor finance based, products for corporations that are operating in the agribusiness sector rather than true lenders to the agribusiness sector. They have generally been quite small scale, they have been for short term seasonal facilities perhaps lasting just a few months, and have generally always been funded in the commercial paper market in Australia. That is market investors are very comfortable investing in because they know their credit risk is virtually zero as their sponsoring bank actually backstops the credit; - so if they want to get out of the asset, or if the asset starts to go bad, the investor does not have to be there to pick up the pieces - it will be the bank.

What we have not seen really is any securitisation of term assets like mortgages over rural property for example, or loans to small/medium entities in the rural sector - this has not occurred and no paper has been placed with term investors – ie investors who are going to be there for five or ten years and who will take the swings and roundabouts of the agricultural business. Likewise, globally and including Australia, we have seen little interest from the banks; - the commercial banks are the main owners of rural credit, as you all know, and frankly they are not really interested in doing anything in this sector.

Why have we had such a sad tale on rural securitisation?



Looking at both sides of the equation – first the asset backed investors – they are information hungry. Asset backed investors want to understand cash flow, they want to understand credit and, typically, an asset backed investor wants a stable and predictable cash flow. He does not want volatility in his payments, he does not want volatility in his interest coverage - he does not really have tolerance for delays in his cash flow. He does not have tolerance for delays due to performance risks, operational risks or quality or price problems. Investors are driven by their understanding of credit. Typically, in this market as in most of the local capital markets, this is driven by rating agencies – a credit rating is essential for any significant term securitisation of assets. The rating agencies do not understand rural credit either and, the rating agencies are extremely conservative. Whenever there is a risk in a transaction that they cannot quantify easily they will introduce some kind of credit enhancement buffer. As the rural sector has a lot of moving parts which have to be understood these buffers become multiples upon multiples of credit enhancement which makes the transactions very expensive for an issuer.

What we do not have, if you contrast the rural sector to the residential mortgage sector, is really a history of losses, a history of arrears, a homogeneous asset class where we can use the probability of losses that have occurred in the past as a proxy for probability for losses in the future. The rural sector is quite diverse. The rural sector has the top twenty businesses of good credit quality while everyone else comes a long way after that. Contrast that to residential mortgages: residential mortgages anywhere in Australia generally will offer the same credit quality standards.

That has really been the problem - getting investors and getting rating agencies to understand the sector. It is simply getting the data - getting the information to be able to assess the credit and to be able to develop a model to enable investors to understand the sector. This information will help to price the risk sufficiently accurately, and once we have a sufficiently close pricing of risk, then the sector becomes much more profitable for non-bank originators to enter and for banks to use securitisations.

The commercial banks are the major owners of rural credit. They have not been interested so far in securitising their rural loan assets. The banks do not securitise for more profit - it costs the banks money to securitise their residential mortgages and yet all of the banks have securitised - all the major banks in Australia have securitised their residential mortgages. Why are they doing this?

What ABS issuers want

Big Four Australian banks are major owners of rural credit and they are focussed on residential mortgage backed issues

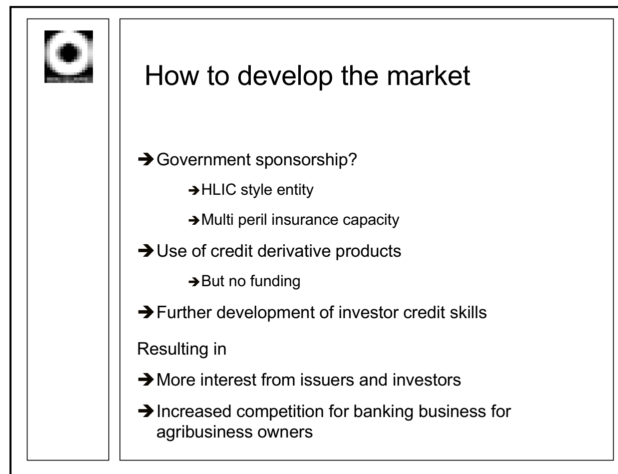
- ➔ Using MBS as a funding tool
- ➔ Capital release through maximising risk transfer
- ➔ Lowest cost
- ➔ Straightforward deal execution
- ➔ Simple ongoing administration

Securitisation of loan assets is a funding tool of the banks. It is a diversification strategy. It is a funding tool for raising capital from the markets. The banks do not make any money out of securitisation - it actually costs them money to do it. If you compare the price for on-balance sheet debt for a major bank to Triple A rated mortgage-backed securities which that bank might originate, the cost is lower for that on-balance sheet debt. Therefore, the question a bank is looking to is which assets it should support on its balance sheet and which to securitise and use as a funding tool. The asset class they are going to look at securitising is the one that is most efficient for them, which is the one that is the cheapest, which is the one that the purchasing investors can class most efficiently, and naturally they are the simplest to understand, like residential mortgages.

Similarly the banks are interested in 'cookie cutter' style transactions, they want to create something that is simple, that investors can understand and which their operational people can understand. Then they can just simply turn the handle and crank out the new deal whenever they need it.

When it comes to rural securitisation, some of the complexities of rural finance have to be compacted into an asset backed security. You can liken an asset backed security to a sort of project finance where the cash flows are actually paying off the debt for a security. In the case of a bank, a bank can absorb a lot of the variabilities or volatilities of those aspects of rural finance - and asset backed securities don't do that. Every single little miniature issue which affects the cash flow or profit in rural credit has to be in some way matched by the asset backed security. That means that it becomes very very difficult in the sense that there are a lot of moving parts, which means there are a lot of people involved and there is a lot of expense going forward. All of this means that banks traditionally do not opt to operate in this area. Likewise we have not seen other people like *Aussie Home Loans* in the rural finance sector or entering this market. Entrepreneurs understand the complexity and the cost which would be required to set up a rural lending arm.

So how can we develop the market going forward?



If you look at the mortgage-backed market even in Australia, you may recall that HLIC, the Housing Loans Insurance Corporation, really kicked off the market some ten years ago. The investors in the domestic market really had not got their head around even residential mortgage-backed securities and there were great quantities of those. HLIC came along and conveniently wrapped the mortgage market and developed the market. HLIC was subsequently sold and yet the programs continued. So this is potentially one idea - this has been tried to some extent in the US with their Farmer Mac programs. It has had some success, but has not been as successful as it might. Loss peril insurance often appears in the newspapers – that is an issue for asset backed securities investors because investors generally have no interest in taking weather risk, or similar styles of operational risk. There is a weather derivatives market that is operating globally but in Australia really it is an extremely small market.

Credit derivatives I think is a new area of technology which does have some application for the rural sector. If you can imagine a credit derivative as being an insurance policy unlike the traditional asset backed security where the asset pays off the security. In the credit derivative what we are really saying is somebody pays the premium and the insurance essentially takes any default on the underlying asset. This is very convenient for capital markets investors because there is a detachment from the underlying cash flows with credit risk. We do not have the problems with interest basis risk for example, or performance quality on arrears and interest.

The problem with credit derivatives of course is that it does not provide funding. A credit insurance policy does not provide funding but what it does give is credit protection. The banks will continue with their mortgage-backed securities program as their funding tool and will be seen to use credit derivatives as a capital management exercise as well as a capital management program to tweak their assets and achieve more efficient capital management.

Likewise, investors need to develop their skills. The securitisation market is still based on rating agencies. There are very few investors who rely on their own credit assessment skills instead of relying on the rating agencies. There are a few sub-investment grade investors, there have been a few high yield investments funds opening in the last year or two, but really it is a very small drop in the bucket. Really this is an area where investors need to develop their own credit understanding more in line with their own capabilities to effect these transactions. Investors in this country who are trying to build up a market need to develop their own skills because often this style of transaction which I think is likely to hit the market in the near future will be small private placement style transactions where it is just not feasible to get the rating agencies involved and the transaction must really rely on the investor's understanding of credit risk.

The Asian and European markets are much more advanced than us, I think, in this regard. Hopefully small scale transactions will result in more interest for issuers, more interest from the borrowers

resulting in more interest from the fund managers. Conceivably this will result in increased competition and perhaps we may even get an *Aussie Home Loans* in the rural sector. It is more likely that the smaller financial institutions that are forced to securitise in one style or another - or perhaps the corporate financiers who need to use securitisation as a funding tool - will be where we will be seeing movement in rural sector securitisation. Some of the smaller and lower rated banks will need to use securitisation as a capital management tool potentially, and that I think is likely to be done by credit derivatives from banks rather than through traditional finance securitisation.

So, in summary, the technology exists in terms of the capability to effect these transactions, in terms of legal and tax capability technologies. The real issue is about an efficient passing of risk, an efficient understanding of the passing of credit risk which you have seen in the successful securitisations. I can execute a rural securitisation quite comfortably, I can even place it with the investors. The problem is that I cannot place it with the investors *at an efficient price* at this stage and that is just putting a stymie on the entire market. Going forward, I think the banks are not likely to do anything, but we will see a little bit of movement in this area from the lower rated financial institutions.♦

4.8 Business in Challenging Times

Mr Kelvin Thomson MP, Shadow Assistant Treasurer

Business is indeed living in challenging times. Some of the challenges come from events largely outside our control - such as globalisation and the internationalisation of our economy, or the relentless march of technology and ceaseless innovation, new ways of doing things. Other challenges are the result of gratuitous Government intervention. As Shadow Assistant Treasurer I am Labor's spokesman on superannuation, and I am conscious of the destructive impact on public confidence in superannuation of frequent Government change carried out, certainly for the last 5 years at least, without any evident vision or coherent retirement incomes framework. There is no doubt in my mind that superannuation is destined to play an increasing role in all forms of finance in Australia, including rural finance.

In the few short years of the Superannuation Guarantee superannuation assets in Australia have skyrocketed from $40 billion to more than $450 billion. I expect superannuation to pass 1 trillion dollars in my political lifetime, and that's not a reflection on my proposed political longevity, merely an indication of how quickly the superannuation pot is growing.

And so I thought this audience might benefit from hearing something about Labor's intentions in relation to superannuation.

But before I go into that in more detail I would like to make reference to another area of Government activity which has caused business to indeed live in challenging times. I refer to the New Tax System and the Business Activity Statement. Earlier this year, in response to an outcry from small business that the New Tax System was making a mockery of John Howard's promise to cut small business red tape by 50%, Kim Beazley established a Federal Parliamentary Labor Party Inquiry into the Business Activity Statement, and into the impact of the New Tax System on small business generally. I have the honour of chairing that Inquiry.

The Inquiry has been touring various cities and electorates in Australia - yesterday we were in Lismore (Page electorate), and this morning we held a hearing in Hornsby (Berowra electorate). We've been seeking written submissions from small business about the impact of the New Tax

System on them, and on ways the workload burden could be lightened and the system simplified. Universally small business have reported a great deal of extra work, and not just the transitional work. Frequently they've spoken of a trebling of the paperwork; eg "I used to spend 1 day per month on paperwork, now I spend 3", or the taxi driver's wife who says "I used to spend 1 hour a night on my husband's books - now it is 3".

They say things like 'Australia is becoming a nation of bookkeepers', and bemoan the way in which BAS work takes them away from what they do best - building their business by providing face to face service to their customers, and they bemoan the way summer holidays and weekends have been sacrificed to the task of tax collecting on behalf of the Government.

They have also alerted Labor to cash flow problems and difficulties caused by debtors taking longer to pay their bills. The BAS Inquiry will be making recommendations to Kim Beazley in due course on how the system can be simplified. Let me emphasise that we are not about subjecting small business to some fresh new compliance horror of the kind visited on them by the Government - we are on about practical changes which will lighten the load. In the meantime, we are continuing to receive submissions, and I welcome any suggestions you may wish to provide.

Let me turn now to superannuation. Labor believes the really big issues in Superannuation to be adequacy, complexity, and interaction with the social security system. We believe these issues are very complex and that they need to be dealt with a view to producing long term bi-partisan solutions.

We have urged this course of action on the Government both prior to the last election and during the life of this Parliament. Notwithstanding the nod-and-a-wink given by Peter Costello and John Howard to the idea of Superannuation Review - Peter Costello raised it after his 2000 Budget and John Howard referred to it as an Agenda Item for the No Agenda cabinet meeting last year - it is quite evident that the Government has no intention of embarking on a Superannuation Review any time soon.

Labor tried to achieve this outcome via the Senate Select Committee on Superannuation and Financial Services. We supported Terms of Reference which would have gone to the areas of adequacy, simplicity, and interaction with social security. Unfortunately the Government refused to agree to these Terms of Reference and regrettably we were not supported by the Democrats as well, even though they had originally proposed such terms.

Labor does intend to hold a Superannuation Review after the next election in the event of a Labor Government. The issues which we will cover and the Terms of Reference will be drawn up in consultation with the Superannuation industry, but will essentially go to the following points:-

- Adequacy - how can we get beyond the current levels in a responsible manner? Labor believes that the Superannuation Guarantee, scheduled to go to 9% in the year 2002, places Australian workers and Australian retirement incomes policy at the forefront of best international practice. Nevertheless we remain concerned that this is not enough. You will recall that prior to the 1996 election Paul Keating had a policy involving 3% Government contributions and 3% employee co-contributions which would have built the aggregate contributions to 15% at no additional cost to employers. While the opportunity for that change has passed, and the money has been frittered away on GST tax cuts, Labor remains interested in how we can build superannuation beyond 9%.

- Simplification: Any discussion of simplification of our complex superannuation rules needs to evaluate the efficacy of the existing taxation arrangements. While a scrapping of contributions taxes would be highly desirable because of the much greater simplicity this would provide and the way in which it would encourage public confidence in and voluntary

contributions towards superannuation, it needs to be appreciated that to do this leaves an immediate $3b problem for the revenue, and any superannuation review needs to come up with a solution to this problem before change can be contemplated.

- Interaction with social security: I believe that we need to do more to encourage people to work from age 55 to 65 and indeed beyond the age of 65. This is one of the points the OECD makes strongly in looking at ageing populations around the world. It has been emphasising for some years now the need to remove disincentives to working later. This may well involve flexible and part-time work arrangements, and it needs a culture shift not only on the part of mature age workers but also on the part of employers, who are too frequently dismissive of the contribution, experience and capacity of older workers.

- Improving Superannuation Guarantee Compliance: While superannuation guarantee compliance generally is good, there are pockets of non-compliance which lead to workers missing out on their entitlements in the event of company insolvency.

- Early release - access to superannuation: While I do not suggest myself that early release should be encouraged, and I am a strong supporter of the sole-purpose test, this is an issue which is consistently put forward by constituents to Members of the Parliament, and our review would inevitably need to consider these concerns and submissions.

- Anomalies: A thorough ongoing review of superannuation should take the opportunity to address anomalies. One example is the problem of people who don't have Superannuation Guarantee paid on their total income. In extreme circumstances some workers have an income which requires them to pay superannuation surcharge tax, but are in fact paid Superannuation Guarantee on about half of that.

PRUDENTIAL ISSUES

I have personally had a great deal of confidence in the regulatory arrangements and prudential supervision of superannuation in Australia. I have been most reluctant to sound the alarm in relation to the safety of superannuation money, and believe the public deserves better than ill-informed speculation and scaremongering on this issue. Having said that, events of recent times cannot be ignored.

The collapse of Commercial Nominees left the superannuation money of a significant number of Australians in jeopardy. The statement by Reserve Bank Governor Ian Macfarlane that he does not believe that the conduct of small superannuation funds - particularly small corporate funds - can be satisfactorily monitored, is clearly a significant statement, one which was subsequently confirmed by APRA. And thirdly, there is the capacity of APRA itself to do the job, a capacity which has been called into serious question by the collapse of HIH Insurances. The collapse of HIH Insurances, with an ultimate shortfall of between $2.7b and $4 billion, is the largest corporate collapse in Australian history. It will leave Federal taxpayers with a $640 million bill, State taxpayers in this State with an additional $600 million bill, and still leaves thousands of policy holders in dire straits. APRA's handling of this matter has filled no-one with confidence. They were aware of the problem from the middle of last year, but chose to work quietly behind the scenes with the company, believing this would minimise the pain for policy-holders. Those policy holders on whose behalf HIH's lawyers settled claims against them for anything up to $½ million, and for which they are now personally liable, beg to differ.

On Tuesday APRA was questioned here in Sydney by the Senate Committee on Superannuation and Financial Services. On at least three occasions their responses gave away the extent to which the Howard Government conceived them as a 'light touch' regulator, and imbued them with a culture

which isn't working and must change. First the APRA was asked about HIH's disastrous purchase of worthless FAI for $300 million, and responded that it didn't care about insurers engaging in transactions that lost money, so long as it didn't threaten their solvency, and yet they cheerfully acknowledged that in the insurance industry solvency is a vague business.

Secondly they were too relaxed about insurance industry law reform. When challenged about the 12 year time frame they'd been working on they were content to say that such things take many years to occur.

I don't think anyone listening would have come away relaxed and comfortable about the state of prudential supervision in Australia.

Superannuation fund members deserve better.

Accordingly, a Labor Government will include in its Review of Superannuation the question of the prudential supervision of superannuation, and we will satisfy ourselves that superannuation money is as safe as it can possible be, or we will make whatever changes are needed to make it as safe as it can possibly be.

The Blair Government in the UK is in the process of introducing Stakeholders Pensions. These are directed at what is referred to as the third quartile of British retirees, those presently earning between 9 to 10,000 pounds per year up to 18 to 20,000 pounds per year.

The Government's view is that for those earning less than 9 to 10,000 pounds per year it is the State Pensions which will cover them and be relevant for their circumstances. On the other hand those earning in excess of 20,000 pounds per year are already largely covered - 90% to 95% - by private pension schemes. Presently, however, those in the third quartile only have 40% to 50% coverage, and the intention of Stakeholder Pensions is to increase their level of retirement incomes.

Companies with more than five employees are obliged to offer access to Stakeholder Pensions if they don't have their own occupational scheme. I note that although the companies must designate a provider, and be willing to collect contributions, the schemes are not mandatory, so the question of take up is all-important. I do not consider the scheme as advanced as Australia's Superannuation Guarantee.

In advance of the scheme coming into operation in April the UK Government has extended the range of people who can take on Stakeholder Pensions. Members of occupational schemes will be able to put money into Stakeholders as well, which adds in another 8 million prospective customers and encourages the market to become involved in these products.

It is clear that overseas pension funds will increase in size, and become an increasingly important potential source of capital.

MASS MARKETED TAX SCHEMES

Many of you will be familiar with the basic structure of many of these mass-marketed schemes.

For example the Budplans involved investors borrowing sums of money such as $24,000, and investing it in the scheme, and claiming a tax deduction for the full $24,000 even though they only had to pay $6,000 if profits didn't emerge.

This looks like tax avoidance to me, and the Tax Office should be tackling the schemes which:

1. Have tax savings as their main selling point
2. Are promoted at the end of the financial year
3. Have the outlay funded by tax refunds or reduced tax instalments
4. Have the investor making a profit even if the venture is a failure
5. Have a tax saving which outweighs the outlay
6. Sounds too good to be true

I do not support round robin schemes, including non-recourse financing.

I acknowledge, however that there have been problems with Tax Office conduct, and the question of interest and penalties remains a relevant one.

IMPROVED ACCESS TO BANKING SERVICES

Labor will work to improve access for Australians to banking services.

Restoring banking services

Labor will work to restore banking services to areas from which they have been removed.

Labor will ensure that levels of banking service provision across Australia are mapped to identify the areas of most need.

Once these areas of most need have been established, Labor will negotiate as part of the Social Charter to have the banks restore those services.

If the banks do not agree to a Social Charter, then a Labor Government will legislate a Charter, and will use the specially established Bank Social Obligations Fund discussed earlier in funding the restoration of services.

Again, this is a fund Labor does not expect to have to establish. Our focus will be on securing agreement for a Social Charter.

Regional Australia

Labor is committed to improving access to regional services - including banking and financial services - through Australia Post and other vehicles.

Last year, Labor announced that Australia Post would play a central role under a Beazley Labor Government as a platform for the delivery of services, including emerging digital data services, particularly to rural and regional Australia.

Labor will release its detailed policy regarding the enhanced delivery of services to rural and regional Australia closer to the election.♦

4.9 Discussion

Chair: Mr Jim Gale, Executive Director, CEDA.

Question: *Mr David Poulter, Agriculture, Fisheries and Forestry, Canberra*: My question is for Robert Harris. You mentioned multi-peril crop insurance as a way of encouraging securitisation in the rural sector. My experience is that is pretty unlikely given the various issues that underlie putting such a scheme in place, but there are other things like farm management deposits which could have a similar role. Would the development of farm management deposits be likely to encourage increased use of securitisation?

Mr Harris: I think this is really a question of a credit enhancement and multi-peril crop insurance was just one of potentially many solutions to the problem of credit enhancement. The real problem with securitizing rural assets is really, I think, the credit enhancement addition necessary to attract investors. Some of the problems that the rural sector suffers from when looked at from an investor point of view is problems with the cash flow being tied so directly to things like the performance of the weather, so things like multi-peril crop insurance can take away some of the risk. You take away that risk in other ways, you can have a cash deposit, you can have a letter of credit, you can do many other things but that is just one way of dealing with that particular risk. I guess the underlying point is that investors in debt securities won't take those kinds of risks, so we have to find a way around dealing with those kinds of issues.

Question: *Michael Hart, Cleary Hoare, Solicitors, Brisbane*: I have a question for Mr Thomson. What is the Labour Party's view on the superannuation contribution surcharge tax?

Mr Thomson: The surcharge in our view hasn't achieved the objectives which were intended for it, and has given rise to a swag of anomalies whereby people on comparatively modest incomes have found themselves subject to the surcharge. As I indicated in my address that it is our intention to examine the taxation arrangements for superannuation, as part of our superannuation review and the examination of the surcharge would be part of that. Now unless you can come up with an appropriate means of offsetting the revenue loss, and there is a substantial revenue hit in relation to the surcharge, then we would not be in a position to get rid of it, but certainly in terms of contributions taxes I think it has a negative effect. One of the other areas that we would be looking at is the administration of the surcharge which falls heavily on the superannuation funds themselves and gives rise to substantial compliance costs. We will be looking at both the administrative mechanism and the surcharge itself as part of the superannuation review.

Question: *Mr Derek Doherty, Rice Marketing Board:* Mr Thomson I would suggest to you that superannuation has been tinkered with for the last ten or twelve years, and the fifteen percent initially was introduced by the previous government and was of course masked as thirty percent, fifteen percent on the way in and fifteen percent on the way out. That's been exacerbated a little bit more as you have pointed out. But there is now the further tax on superannuation savers which would affect most of the people in this room. There was no economic rationale to the first fifteen percent. I was Chairman of a life insurance company at the time and we felt that the logic showed that people should, on an assessable basis, start with a superannuation fund and not pay tax on that until such time as the users - the net recipients - could pay at appropriate rates which in many cases would be much less than the forty-five percent that you are paying now. You have already highlighted the fact that now it has become such a high revenue source that it would be difficult to turn it off but I would hope that when you do your review you would find a way of making superannuation more attractive to the population.

Mr Thomson: That is certainly fair comment and it is our intention as part of the review to examine the taxation arrangements. As I indicated also in my remarks, that there is a several billion dollar issue here in relation to contributions taxes and you would need to have a way of addressing that. Various proposals have been put forward from within the superannuation industry and people have taken an interest in these things, and we want the opportunity to examine those proposals and see if they are feasible. Some of the suggestions relate to moving the taxation to the end benefit and taxation at marginal rates and so on. There is some appeal about that but what it leaves you with is

large transitional issues for both the government in terms of the immediate loss of revenue and how you deal with it in year one of the budget, year two and so on, and also potentially of course, transitional issues for the fund members and you have got to make sure that there aren't individuals who are disadvantaged as a result of that kind of change. But we are interested in terms of superannuation review in examining these things and producing a system which is simpler and easier to understand. I think that the complexity of the existing arrangements is destructive and one which does not encourage voluntary contributions.

Question: *Mr Stephen Carroll, Australian Bankers Association:* At the moment there is all this water reform which is going on around all the States at present. The implications of that reform is to separate water rights from land titles and typically the States are giving water a miss as far as implications for quality of rural credit are concerned. But stripping water rights from land titles does affect net profitability of rural enterprises and their creditworthiness. I would just like your comments on what you think the implications of that might be, heading down the path towards securitisation of the rural sector.

Mr Harris: This stuff goes back to the previous question in point. Investors won't take those kind of risks and we need to find a way around either deflecting the credit risk from the water rights and the like or in some other way enhance the structures so that risk can be taken care of with other means. That might be by over-collateralising the risk structure so that we have more assets than liabilities or it might be just achieving some other, hardier, structure to take up those kind of risks. But splitting up land titles and water rights and putting the cash flows at risk through problems with water management rights is one of the worst possible things that one could do to a securitisation structure from the financier's point of view. It's another risk being introduced which someone then has to pay to get rid of before the security can be made attractive to investors.

Question: *(Questioner not identified):* With the growing amount of superannuation funds available to invest, what does Labour have in mind to find channels for that in relation to their ideas for development projects?

Mr Thomson: I think from our point of view you would need to make the strong distinction between encouraging investment in a particular directions and directing investment to go in particular directions. I can tell you that I and we do not support the latter. Before I was in the Federal Parliament I was in the Victorian Parliament and I had to live with the wash up of the failure of Tricontinental and the VEDC and so on and I developed an aversion to the government telling people where their money should go. It is a very dangerous practice. Having said that, in terms of encouraging superannuation funds to look to particular areas of development, that is certainly something we are supportive of. There are things that happen now in relation to Develop Australia Funds and initiatives of that kind. The Victorian government has been doing work through its local government superannuation fund to have investment going into regional Victoria, so there is the potential for more in the way of those sorts of initiatives. The other thing I would mention to you is the choice of superannuation debate. Our position is not supportive of the government's legislation regarding the choice of funds but we are interested in the idea of choice of investment and requiring the funds to offer their fund members a range of investment choices. It is possible that within that range of investment choices you could see choices developing which involve an interest in rural and regional projects or various other kinds of investments that fund members become interested in, or could be persuaded to become interested in.

Question: *Michael Hart, Cleary Hoare Solicitors Brisbane:* I know you haven't touched on the entity tax system this morning, but it will be touched on by others this afternoon. The current government introduced it, and then deferred it and maybe scrapped it, but it has as much prospect of causing anger for small business or private business as has the conceptual and mechanical mistakes of the GST. Does Labor have a view on the entity tax system?

Mr Thomson: We are neither committed to proceeding with it or to scrapping it. So when they drop entity taxation or they drop other parts of the package it feels like a con from where we sit, but I understand concerns that have been raised about entity taxation. I also say to you that I don't think that people ought to get a tax advantage from arranging their affairs through one financial vehicle as compared with another, through a trust as compared with a company or a partnership. So there are a range of considerations there which we will be having a look at and it looks as if the government won't be bringing on the entity taxation legislation before the election so it is a matter that would be considered by us in due course.

Question: *Dr Terry Dwyer, Australian National University:* In terms of credit enhancement, Robert Harris mentioned that often it would be a letter of credit or a guarantee. Such letters of credit or guarantees would usually be given by financial institutions. In terms of attracting international investment to a national market, I would have thought the credit worthiness of those financial institutions itself and the credibility of their regulation would be a major factor. Let me put it this way: there is not much point to having a letter of credit from an insurance company like HIH for your securitised product. Does anyone have any comments to make on the credibility of Australian financial markets when there have been suggestions now in *The Financial Review* that not only does the Commonwealth have no obligation to ensure that policy obligations to policyholders with insurers are met, but actually there is no legal obligation on the Reserve Bank to ensure that depositors in banks ever see their money back if a bank fails? I was quite surprised by these comments being made in *The Financial Review* and I wondered what is this doing for Australia's credibility as a global financial centre.

Mr Harris: Funnily enough, investors will take financial credit risk, they are happy with letters of credit. The reason is that they know who the letter of credit is from, so they can factor into their analysis that not only do they have default risk on the underlying asset, but there is also some enhancement provided by somebody. They will factor that into their analysis as well. What we have seen historically globally is some useful developments in the market which has been a downgrading of a financial institution that is providing credit enhancement. What this has had the effect of doing in a strange way is promoting the market because investors have realised that it is not a theoretical risk that they are running and that in fact if an insurer is downgraded or goes insolvent their credit enhancement is worthless. Subsequent to that, although the underlying assets may be performing perfectly well, when the next transaction comes along investors will not allow those kinds of transactions to go forward. In my presentation I alluded to HLIC. In some ways HLIC has been the worst thing we could do to our market because it has mollycoddled investors to a certain extent, allowing them to expect not to take any credit risk. But if you look at the European market where they have had downgrades in the insurance sector, investors have insisted that the credit enhancement is provided by cash - quite often in subordinated securities or some investment grade securities or often cash based assets. We have had that in this market and that has to a certain extent slowed the development of the market and made the market less efficient in being able to accept new and innovative structures and unusual assets, because investors are still looking for the fabulous credit enhancement that HLIC was providing and those times are definitely gone. It has become a very slow process in getting investors to look at these kinds of risks and advanced enhancements.

Question: *Mr Barry Buffier:* My question is now to Bruce Brown in relation to the valuation methodology and there is a certain degree of discrimination there. I was wondering if you would expand a little bit further in relation to salinity and sustainable farming practices and the effect that might have on capital values and can you see a move to approaches into rural land requiring vendors to appraise it, so they understand exactly what it is that they are buying.

Mr Brown: It is a good question. I think sustainability is obviously a problem in the valuation process, but I think there are a new set of tools which are becoming available for valuers, and indeed banks, and that new set of tools really relies on satellite imagery. I mean it is amazing what a satellite can do now. For example I was only talking with a company in Canberra the other day and

obviously sustainability and salinity are big deals for purchasers of agricultural land including the sellers who want to get out before the salinity becomes obvious. There are very major portfolios which could in fact be substantially wounded by some of the salinity developments perhaps over the next decade or so. But what we are really talking about is the "eye in the sky" monitors which pick up salinity now before it's being visible to valuers on the ground. And it happens by infra-red imagery where the field temperature, if you like, of the vegetation in the area which is going saline will actually be higher than that of the surrounding vegetation and will register on a satellite image.

Question: *(Questioner not identified):* What is the Opposition's view on adequacy of financial sector regulation given the HIH Insurance collapse?

Mr Thomson: We are amazed at how long it took the Government to realise how serious a problem this was. We support the policyholder rescue package, which it is now putting in place. There is certainly a distinction in my mind between shareholders on the one hand and policyholders on the other. As for the view that does the rounds of the insurance industry that they should not be obliged to contribute to any bailout of this character and that, if you like, the good companies should not be obliged to subsidise the bad, it is worth noting that there are a range of areas in which provision for industry contributions amid debacles is made. In the area of superannuation there is a capacity to levy the funds to compensate members in case there is theft or fraud. Similarly areas like travel agents and bookmakers and so on have various schemes in place to try and give people some assurance that their money will not go west.

Mr Brown: If I could make a comment, I think there is a bit of a furphy going around. I am not going to comment about insurance companies. But, if I am talking about the major banks in Australia which are internationally rated anyway, and which are in fact regularly supervised by the RBA, I have sat through some of the rulings on rural portfolios over time, actually from the RBA, and there is no risk to bank deposits actually in Australia. But let me go on one further step if we are going to talk about regulation in banking. One only has to look at the benefits of bank deregulation rather than regulation. If we are talking about a social charter for banks - why don't we turn it round? With pullback of the major trading banks in some areas because of the less than profitable nature of those activities, it has simply created some massive opportunities for some of the lower ranked institutions which we've talked about - the credit unions, or some of the partnership or community banking ventures, so there has been a substitution of services. At the same time there is nothing to stop these entities, and I support some of Robert Harris's comments where, because they are lowly ranked in terms of rating, they may in fact also involve themselves in rural lending via some form of co-operative securitisation vehicle. So we haven't actually seen the bush deserted. We have seen actually a new level of supplier come in with profitability parameters perhaps somewhat different to the fully listed banks.

Question: *(Questioner not identified):* Mr Thomson, in the late 1950s the Income Tax Assessment Act was about two and a half centimetres thick and about two or three years ago the Act and Regulations made it over a metre and of course you now you have the GST on top of that. I was just wondering if get into power and you have a review of taxation would you review whether that the metre is more efficient than the two and a half centimetres?

Mr Thomson: A very good point. We have been making it ourselves in Parliamentary debate as each new piece of tax legislation comes through. I am personally conscious of this because when all the boring and turgid taxation legislation labours its way through the Parliament, I am the Opposition spokesman in these areas, so I get to see it in living colour. We now tend to weigh it rather than count the pages and talk about how many kilograms we are dealing with. I think it is destructive that the Tax Act has expanded in the way that it has, it has really trebled in size in the last five years. This means that not only does an ordinary person have no hope of understanding what their taxation obligations are, it's not even feasible for accountants and tax agents and lawyers and business people to understand the provisions of the Act either, or the Tax Office itself. People have many queries in

relation to GST, and simply cannot get an answer from the Tax Office one way or the other, so this is unhelpful. It seems to me that it would be desirable to try and send the Tax Act in the opposite direction. I am not in a position to make any promises about that but I am simply saying that I think it would be better if we had a smaller Tax Act rather than the one we've got.♦

Afternoon Session Chair: Mr David Ginns, Executive Director, Agribusiness Association of Australia

4.10 Taxation and Superannuation Obstacles to Rural Investment

Mr Michael Hart, Partner, Cleary Hoare Solicitors

Introduction

As others have pointed out, it may be that future funding of rural activity may occur through much more varied methods and levels.

Nonetheless, the structure through which the farm and other tangible assets will be held will remain critical to:

- the principals behind the project, eg, the farmer;
- the other participants, to the extent that the stability of the principals is relevant.

Structures

Traditional farm holding structures are:

Ordinary partnerships;
Private companies;
Private trust structures.

Commonly, the shares in private companies are held by the individuals but, increasingly, they will be held by private trusts.

Trusts can take a variety of forms:

- the family trust (the traditional form of discretionary trust but modernised to meet current needs);
- a unit trust under which equity entitlements are identified by the proportion of units held. Very often, the units will be held by discretionary trusts representing different families or different levels of families;
- hybrid trusts, eg, a unit trust but with features of a discretionary trust superimposed to allow for more flexibility to deal with family needs and to reward “good performers”.

Historically, there has been a desire by Australian farming families to keep the farms within the family, although, in many areas, eg, in the sugar cane areas, the current generation reaching adulthood are very often rejecting farming life so that the parents, in their 60s, are being faced with decisions they thought they would never have to face, eg, sell the farm outside the family.

Even though there is no capital gains tax on death, there are capital gains consequences as a result of a death, eg, pre CGT assets become post CGT assets.

There is a strong desire/need within the farming community to prevent death from causing ownership changes of assets. The only way this can be achieved is to use discretionary trusts – to take trusts back to their original purpose of many centuries ago. Increasingly, therefore, there is a move towards having farming properties owned by trust structures with the "final equity" being owned by discretionary trusts representing the respective families.

Statistics tell us that the divorce rate in Australia is approaching 46%. Bearing in mind that farming properties have, traditionally, provided a very low rate of return *on the value of the property*, very few farming families can, via raising farm debt, finance a departing spouse. Very often, divorce will cause the sale of a farm.

As with any large problems, remedies will be developed for them. What has occurred in the last 10 years is the development of a special form of discretionary trust, namely, the Bloodline Trust, the essential features of which are:

- assets must remain in bloodline;
- income can be spread amongst the bloodline and non bloodline.

Investment Structures

Other speakers have referred to the use of limited partnerships and unit trusts on a widely held basis.

The essence of a limited partnership is to divide the partners into two classes:

- the managing partner or general partner;
- the limited partners.

The limited partners contribute capital to the venture but they are protected from all liabilities beyond the obligation to contribute an agreed amount of capital.

The managing partner or general partner manages the partnership (the limited partners are prohibited from participating in management) but bear all liability.

This is not unlike a unit trust in which the unitholders have an obligation to contribute an agreed amount of capital but the trustee fulfils the same role as the general partner or managing partner in a limited partnership – the trustee bears liability to outside parties.

In either case, ie, a limited partnership or the unit trust, the general or managing partner and the trustee have access to the assets of the structure to meet its liabilities.

Until taxation changes in the early 90s, the limited partnership was a very favoured vehicle through which to attract investment moneys for risk projects.

Taxation of Structures

Ordinary partnerships (and limited partnerships until the early 90s) are taxed on a "look through" basis. In other words, the entity itself does not bear tax but the participants are liable to tax according to their entitlements from the project.

Companies, on the other hand, are taxed as a separate entity and, currently, at a flat rate of 34% and reducing to 30% next year. Any attempt to move benefits from the company to private shareholders (or associates) from the after tax profit will generally be a dividend or a deemed dividend and assessable to the shareholder (or associates) but, in the case of fully franked dividends (as distinct from deemed dividends), with the benefit of franking credits.

Trusts can, in theory, be taxed on either of those bases although, in reality, they will always be taxed on a "look through" basis (except for losses). This is because, if the trustee does not allocate income, it will be taxed at the highest rate of tax. On the other hand, if it allocates income, the beneficiary entitled to the income will be taxed on the rate of tax appropriate to that beneficiary.

In practice, because of the penalty for retaining reserves within the trust, all incomes is allocated. This is a distinct disadvantage when the enterprise wants to retain working capital reserves. In practice, in private families, entitlements to income, although allocated, are very often not drawn, or drawn only partially.

Losses

For taxation purposes, losses are quarantined in companies, trusts and limited partnerships.

For ordinary partnerships, they are taxed on a "look through" basis.

In addition, there are very strict restrictions against the use of quarantined losses. If losses were, for taxation purposes, treated on a "look through" basis – as for partnerships – there would be no need for restrictions upon the use of losses.

Limited Partnerships

In 1992, because of the risk perceived by Treasury via an anticipated "overuse" of limited partnerships for infrastructure development, taxation laws for limited partnerships were changed so that they were no longer taxed as ordinary partnerships but were taxable as companies.

Overnight, the attractiveness of limited partnerships disappeared – all through a fear of what might be, and without analysis of whether, even if the fear became reality, the advantages to industry and to the nation might outweigh the feared evil.

The reasons for the loss of attraction are:

- New projects often generate losses in the early years;
- On a full "look through" basis, eg, in an ordinary partnership, the participants' shares of losses can be offset against their other income;
- This availability increases the overall net return to the investor;
- With its removal, it was not possible to make the returns sufficient to offset the risk.

Taxation Reform

Embodied in "A New Tax System" announced in August '98 (before the last election) were:

- a proposal to extend fringe benefits tax to any benefits coming from a trustee to a beneficiary, whether via an employer/employee relationship or not;
- the Entity Taxation System.

The FBT proposal was equivalent to a de facto death duty; almost all Wills create trusts so that when the estate is wound up and the estate assets pass to the estate beneficiaries, FBT would have been payable to 48.5% on the estate – *de facto death duties*. Mercifully and sensibly, after intense lobbying, this proposal was abandoned. However, the abandonment was justified by the Ralph Committee on the basis that the Entity Taxation System would solve all the perceived evils that flow from trust relationships in terms of capital.

The thrust of the Entity Taxation System was to treat all trusts (except for a very limited excluded class) as companies so that the trust would be taxed as a company and beneficiaries would be taxed as shareholders.

However, tacked on to the Entity Tax System was the Profits First Rule. The essence of this was that all benefits flowing from trusts to beneficiaries would be deemed to come out of profits, if there were any. There is nothing unusual in this per se because, currently, as noted above, all net income of trusts is distributed annually to avoid penalty tax at the trustee level.

However, profits were defined to include unrealised gains. The result of this was that, even if a trustee attempted to distribute pure capital to a beneficiary, the trustee would be deemed to be distributing the unrealised gain out of a trust asset, if the trust had an asset with an unrealised gain. In addition, when the trust ultimately sold the asset and realised the gain, it would be subject to capital gains tax. All of this was a *defacto wealth tax*, as well as double taxation.

If that wasn't bad enough, tacked onto the Profits First Rule was the Non Commercial Loans Rule. This meant that if I lent money to my own trust and did not charge it and receive interest annually for seven years and did not have the loan capital repaid within seven years (not always possible in developing businesses and almost impossible to be certain about in rural enterprise), then*, when my loan capital was repaid to me*, it would be taxed as a deemed distribution of profit, if the trust had an asset with an unrealised gain. This was equivalent to triple taxation. Loan capital is usually after tax money anyway (the first point of taxation), repayment of my own loan was to be taxed as if it was a distribution of profit (second point of taxation), and the ultimate sale of the asset with the unrealised gain would bear capital gains tax (third point of taxation).

Again, after intensive lobbying – very political lobbying – this proposal was rejected by the National Party.

Based on press releases in January this year by the Treasurer and by the Deputy Prime Minister, and based on a press release of 22 Mary this year by the Treasurer, the only reasonable interpretation is that these proposals have been scrapped by this Government. In particular, Cleary Hoare has an e-mail from the Treasurer's Office dated 20 April 2001 under which the Treasurer's Office states that the Treasurer's press release of 22 December 1999 is no longer relevant (this is a press release via which the Treasurer announced the intention to embrace those parts of the Ralph Report recommending the Entity Taxation System).

On the other hand, the budget papers allocate moneys for further consultations by the Board of Taxation on the Entity Taxation System.

The Entity Taxation System represents:

- the fulfilment of the zealous desires of people within Treasury and the ATO who regard trusts as evil;
- an attempt at *de facto death duties* and *de facto wealth tax*.

To put this in proper context, reference should be made to parts of "A Platform for Consultation" issued by the Ralph Report in February '99, which contains statements to the effect that:

"The Review is asked to explore opportunities for increasing the economic efficiency of taxation by bringing tax value and commercial value closer together" (papa 8 Overview).

"The framework adopted throughout this discussion paper is driven by the concept, consistent with the Review's terms of reference, of moving tax value closer to commercial value" (para 98 Overview).

Comprehensive income of the business investor = Annual receipts (less costs) + changes in value of the underlying assets and liabilities. A number of benefits flow from this approach (paras 100-103 Overview).

Any departures from the comprehensive income concept should be transparently identified (para 106 Overview).

In addition to the proposal to expand FBT (rejected) and the Entity Taxation System (at least deferred and may be rejected), a proposal was hatched by the Ralph Committee for what was initially called Option 2 and is now called the Tax Value Method. The essence of this approach is that notions of income and capital for taxation purposes will be discarded and movements in net positions will be taxed annually, although net positions will be based on tax values rather than asset values. Initially, the hope of the Ralph Committee, (refer paragraph above) was to tax movement in asset values but they recognised that this would be untenable.

The purported benefit from the TVM is that entities would account for taxation purposes in the same way that they account for public reporting purposes. That may suit public companies *but it does not suit private enterprise and, particularly, rural enterprise. The sample legislation released with the Ralph Report in July '99 is mind boggling in complexity. While the concept may sound simple, the myriad adjustments and modifications make the complexity of the tax reform process so far, eg, GST, seem simple compared to the TVM.*

There is absolutely nothing of benefit in the TVM for private enterprise. Further, many commentators believe that the TVM is simply the first step in a proposal by zealots in Treasury to move to an AVM – asset value method. In other words it is seen as a first step in a proposal to totally disregard notions of income and capital and to simple tax all Australians on net movements in asset values – a wealth tax.

In addition to the attack on private investment structures, Division 35 of the Income Tax Assessment Act 1997, operative from 1 July 1999, is designed to discourage investment in projects which initially will generate losses – by quarantining their losses.

Apart from the genuine broadening of CGT relief for small business assets, *there has been absolutely nothing in the tax reform process to benefit small business.*

The Future

As other presenters have said, there is no justification in distinguishing between the taxation of the various structures – at least in terms of private capital.

All structures should be taxed on a "look through" basis as private structures in USA are. (Subchapter S Corporations)

In particular, to facilitate external investment at whatever level and via whatever method:

- limited partnerships should be taxed on a "look through" basis;
- unit trusts should be taxed on a "look through" basis; currently, whilst profit is taxed on a "look through" basis, losses are not.

Inter-generational Issues

The inter-generational movement/retention of farms is a critical issue in Australia and will remain so. This is not to say that market forces won't or should not alter the size of holdings.

The only structures which permit this in a seamless manner are structures which have discretionary trusts "at the bottom". *There should be no penalty for the use of structures which allow asset stability inter-generationally.*

The Entity Taxation System and the proposal to extend FBT (see above paragraph) attacked the use of trusts for inter-generational stability.

There are some current uncertainties which lead to disadvantages for trusts in the capital gains tax area:

- the discount gain is available to trusts (as it is for individuals and superannuation funds) if an asset is held for twelve months;
- it is becoming increasingly common for testators to leave farming assets to Bloodline Trusts representing their children instead of leaving the assets to the children themselves (for asset protection purposes). If the assets are left to the children themselves, then the children will have the ownership starting point of the testator, ie, if their parent had bought the asset in 1998 then the beneficiary will be deemed to have bought the asset in 1998 (for the purposes of the one year ownership threshold to access the discount gain).

There is doubt about whether this extends to an asset moving from a testator to a testamentary trust/discretionary trust representing the children.

The Ralph Report (July '99) recommended that this be confirmed although it seemed to accept that such was the current law. The matter should be clarified.

Superannuation

For many years now, "in house asset rules" have applied to self managed superannuation funds. The thrust of these rules is to limit investment of the super fund moneys (usually to no more than 5% of the whole fund) in intra group or intra family investments.

In the '98 Budget, further severe restrictions were announced in this respect, operative from May '98. In the result, following a Senate Committee Inquiry, they became operative from 11 August '99 but still imposed more restrictions against intra group investment.

This is to prevent the supposed evil of all intra group investments. In fact, many intra group investments can be the very best investment a superannuation fund can enter. Very often, the return

on investments within the group will be much higher than that available externally. Further, there needs to be a balance between the use of the funds, return on funds, and security.

More critically, for regional areas, to the extent that the self managed superannuation fund is required to invest externally, those moneys are extracted from the regions and moved to the capital cities and internationally.

There should be real consultation between those experienced in advising small business and rural business and those in the bureaucracy to find a proper balance for the guidelines for investment by self managed superannuation funds. It may be that the guidelines should:

- lift the percentage of assets which can be invested in in-house assets; and
- require some external valuation/certification process, but not by Government.

Other Tax Issues

Over many decades, there have been tax incentives for investment in rural enterprise. In more recent times, there seems to be a move away from this.

The purpose of this paper is not to advocate one approach as against the other but simply to state that, whatever approach is taken, investment in rural enterprise should not be discriminated against.

Further, academic purity does not necessarily equate to the best result. If, academically, it is considered that tax incentives distort investment, this is not necessarily a bad thing so long as matters are reviewed from time to time and so long as the purposes are identified and monitored.

Conclusion

Investment in private enterprise is disadvantaged by an inappropriate approach to taxation of private enterprise structures. There should be a broad distinction between private enterprise and public enterprise and all private enterprise entities should be taxed on a “look through” basis.

In particular, to facilitate external investment in private enterprise, at whatever level and via whatever method:

- limited partnerships should be taxed on a “look through” basis;
- unit trusts should be taxed on a “look through” basis;
- in addition, realistic guidelines should be applied to investments by self managed superannuation funds – not academically driven guidelines based upon a perception that private enterprise cannot be trusted. ♦

4.11 Equity Finance and ASX Requirements

Mr Russell Mailler, National Business Development Manager, Australian Stock Exchange Limited

I am here today to talk about raising equity and listing on ASX. While listing on ASX offers significant advantages, it will not be appropriate for all entities. When considering this step, entities should consult their professional advisers, including accountants, lawyers and corporate advisers.

ADVANTAGES AND DISADVANTAGES OF LISTING ON ASX

The advantages of listing on ASX include the following:

- *Access to investment community.* Listing can provide greater access to the investment community and to capital.

- *Raised profile.* Listing can enhance the profile of an entity in the investment community and generate greater awareness of the entity's products or services. The publicity received may benefit the entity's business and its raised profile may increase the standing and reputation of the business within its particular industry.

- *Benefits to employees.* Listing provides an opportunity for an entity to further motivate its staff through the introduction of an employee incentive scheme. Employees would therefore be given an opportunity to share in the growth of the entity.

Listing on ASX, however, raises a number of issues that need to be taken into account:

- *Cost of listing.* The initial public offer process is not inexpensive, in terms of cash costs as well as time costs of senior executives. A prospectus needs to be prepared and various advisers need to be appointed.

- *Cost of continued compliance.* After listing on ASX, the entity is required to comply with various regulations including those relating to disclosure. Entities are required to ensure that the market is fully informed at all times to ensure that investors are in a position to make informed investment decisions.

- *Reduced control.* Once an entity is listed, the potential for a change of control is increased. Potential purchasers are able to accumulate a holding in the entity via on-market purchases of shares or via a takeover offer.

LISTING PROCESS

The initial public offer prospectus can take a considerable length of time and would typically follow the following steps:

- *Restructure of the organisation.* In consultation with legal, tax and corporate advisers, it is necessary for the organisation to identify the most appropriate structure for the listed entity. When looking at this matter, it is important to take into account taxation, regulation and operational issues.

- *Preparation of the prospectus.* This process involves a considerable time commitment from senior management. The prospectus must contain all information about the entity that investors would reasonably require to make an informed investment decision. A due diligence process is conducted as part of the prospectus preparation process to ensure that the prospectus complies with all legal requirements and that no material information is left out of the prospectus.

- *Prospectus Capital Raising.* The offer period is typically three to six weeks, however there is no minimum time set by the Corporations Law or Listing Rules.

- *Compliance with ASX requirements.* Compliance with the ASX requirements generally occurs following the close of the offer period. The ASX admission requirements are discussed below.

- *Listing on ASX.* The admission of the entity to the official list of ASX occurs once compliance with the admission requirements has been demonstrated. The securities of the entity can commence quotation on any business day.

ADMISSION REQUIREMENTS

The primary requirements that must be met by entities considering listing on ASX are as follows:

- *Constitution.* The entity must have a constitution that is consistent with the listing rules.

- *Prospectus.* A prospectus must be issued and lodged with the Australian Securities and Investments Commission.

- *Security holder spread.* An entity must either have 500 shareholders holding parcels valued at $2,000 or 400 shareholders holding parcels valued at $2,000 with at least 25% of the shares held by persons who are not related parties of the entity.

- *Profit test or asset test.* Applicants are required to satisfy either the profit test or the asset test. Under the profit test, the key requirements are that the entity's aggregated profit from continuing operations for the last three full financial years must have been at least $1 million and for the last 12 months at least $400,000.

  The assets test is designed for those entities that do not have a sufficient profit history to satisfy the profit test. This test requires the applicant to demonstrate net tangible assets of at least $2 million after deducting the costs of fund raising or a market capitalisation of $10 million. In addition to this, the entity must have less than half of its total tangible assets in cash or commitments consistent with its business objectives to spend at least half of its cash.

ONGOING DISCLOSURE REQUIREMENTS

Listing rule 3.1 forms the core of ASX's continuous disclosure regime and is based on the following principle:

Timely disclosure must be made of information which may affect security values or influence investment decisions, and information in which security holders, investors and ASX have a legitimate interest.

The language of the obligation to disclose under listing rule 3.1 is similar to the language used in section 1001A of the Corporations Law. An entity must disclose information if a reasonable person would expect that information to have a material effect on the price or value of the securities. A reasonable person is taken to expect information to have a material effect on the price or value of securities if it would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell the securities.

CO-OPERATIVES

A significant number of co-operatives, converted co-operatives, companies limited by guarantee which operate on co-operative principles, and mutual business entities face special problems that prevent their complying with the listing rules dealing with control issues.

These entities have special historical characteristics and current requirements that make it difficult, if not impossible, for them to meet the standard listing requirements. ASX believes that there are advantages for the economy in having a transparent secondary market for these entities and is prepared to consider relief to allow a wider range of structures for them than it will allow for other listing applicants. However, ASX expects the entities to have regard to its preference for more orthodox structures and to move to such structures over time as they adjust to market circumstances.

While ASX is proposing a flexible approach to the listing of these entities to address control issues, ASX has a preferred model for listing which is discussed further below. The entities to which relief may be available can be identified by reference to many, or all, of the following characteristics.

- Their history and evolution.
- Their functioning in accordance with co-operative principles or mutual principles. For example, the co-operative principles have been incorporated in legislation (NSW Co-operatives Act, section 6).
- Their regulation is or has been principally under special state legislation (eg. co-operatives legislation), not the Corporations Law.
- Their membership (ownership) is limited to suppliers, producers or customers.
- Taxation treatment is as a co-operative or mutual.
- There are restrictions on the transfer of their securities.
- Initial investment in them was divided over the initial membership according to a formula (eg. equal shares or according to patronage).

Shareholder limits

Co-operatives legislation currently restricts the holding of shares to active members, and makes the transfer of shares subject to certain restrictions (eg. board approval). The legislation limits the scope for trading ownership interests. This is very likely to limit the availability of access to the market in relation to the equity of co-operatives subject to the co-operatives legislation.

However, if a mechanism were available to allow the quoting of shares in a co-operative, a question arises about limits on ownership. There may be a limit imposed by legislation on the number of shares that may be held by a member of a co-operative (eg. Victorian Co-operatives Act, section 174). Security holder limits in legislation often are accompanied by disenfranchisement and divestment. Listing rules 6.10 and 6.12 allow disenfranchisement and divestment to occur under Australian legislation.

Listing rule 6.10 restricts the circumstances in which voting rights and dividend rights can be changed or removed. However, listing rule 6.10.4 allows a security holder’s right to vote or receive dividends to change in the following circumstances:

The right is removed or changed under Australian legislation, or under a provision in the entity's constitution that must be included to comply with Australian legislation. Any provision must cease to operate once it is no longer necessary.

Listing rule 6.12 restricts the divestment of equity securities. However, listing rule 6.12.1 allows divestment in the following circumstances:

The divestment is under Australian legislation, and the mechanism the entity adopts for divesting the security is set out in the legislation, or is approved by ASX as appropriate and equitable. Any provision in the entity's constitution must cease to operate once it is no longer necessary.

Thus, if shares in a co-operative can be quoted, the entity may be able to have a shareholder limit.

One member - one vote

Many co-operatives have one vote per member, reflecting the legislation under which they were formed, and their history and nature. ASX will consider waiving listing rule 6.9 (dealing with voting rights of equity securities) to allow 'one member - one vote' structures if it is required by the Co-operatives Act of the state regulating the co-operative.

Converted co-operatives

Converted co-operatives are entities that have converted from structures governed by co-operatives legislation to structures governed by the Corporations Law. Being subject to the Corporations Law, these companies do not have the legislative restrictions on share ownership applicable to co-operatives. However, many converted co-operatives want to retain an aspect of their co-operative nature. Some seek to do so by imposing a limit on the number of shares that may be acquired. Usually the limit is not supported by legislation. Shareholder limits are often enforced by curtailing the voting rights of security holders whose holdings breach the limit set out in the constitution of the entity. There are usually also mechanisms for the forced disposal of securities above the limit. The limit was often a basis for conversion to a company from a traditional co-operative.

As noted in relation to co-operatives, listing rules 6.10 and 6.12 allow disenfranchisement and divestment to occur under Australian legislation. If there is no legislative limit, the listing rules allow divestment and disenfranchisement under a provision in the entity's constitution that ASX has approved as appropriate and equitable (listing rules 6.10.5 and 6.12.3).

Matters that ASX will have regard to when considering whether divestment and disenfranchisement provisions are appropriate and equitable include the following.

- Whether the limit in the constitution of a converted co-operative is reasonable.

- Whether the mechanisms to effect divestment and disenfranchisement are themselves appropriate and equitable (eg. only operating on shares in excess of the limit, not being unnecessarily onerous, operating in clearly defined circumstances, complying with the SCH Business Rules, divestment occurring only after adequate notice, etc.)

- The benefit to the security holders as a whole.

- The extent to which the provisions may entrench existing control.

Given the special considerations that may apply in the case of a converted co-operative, ASX will consider allowing a shareholder limit. Normally ASX would expect an entity to adopt a limit of not less than 10 per cent, but in exceptional circumstances ASX may accept a limit of not less than 5 per cent. Exceptional circumstances would include, for example, a statutory limit set at that level.

Another possibility that ASX would consider is for the constitution to impose voting restrictions and divestment at different levels (eg. a voting restriction on shares held above 10 per cent and divestment of shares held above, say, 15 per cent).

Given ASX's view that converted co-operatives should move to more orthodox structures over time, ASX considers that the provision setting the limit should not initially operate for more than 5 years from listing, and its operation should be considered again no more than 5 years after the last reconsideration. The reconsideration may be either by a resolution to continue the provision's operation or a resolution to end its operation. (The entity may decide which form it prefers for the provision.) In either case, the vote may be by ordinary resolution. If the provision is framed to require a vote on whether to continue the limit, ASX is prepared to agree to a special resolution if the entity wants. However, a special resolution would not be acceptable if the provision requires a vote on whether to end the operation of the limit, because the entrenchment impact is too great.

In the process of preparing for listing, entities may need to seek the approval of members for various changes (eg. changes to articles). If there is a meeting of members at any stage of the planning for the listing, ASX will expect that the introduction of a shareholder limit is put to members as a separate matter for them to decide.

A vote on the introduction of the limit, and regular reconsiderations, gives members an opportunity to consider the advantages and disadvantages of a limit. ASX would expect adequate information concerning the advantages and disadvantages of the limit to be given to members at the time of any vote.

ASX would normally expect the existence of the limit to be conditional on the following.

- There is no right to refuse to register transfers to enforce the limit (see listing rule 8.10).
- Divestment and disenfranchisement is by acceptable mechanisms, involving appropriate notice.
- The limit can be removed at any time (ie. the provision is not entrenched and, for example, if it is in articles of association, could be removed by a special resolution of members).
- Any other conditions that ASX decides are warranted given the structure.

Founding shares

Another way that control issues might be addressed is by the use of a special share, sometimes called a founding share or golden share. ASX will consider waiving listing rule 6.9 (dealing with voting rights of equity securities) to allow a founding share. However, ASX considers that its preferred model for listing delivers the protection for the interests of active members that a founding share can deliver, without complicating the structure of the listed entity.

Consistent with shareholder limit structures, the introduction of a founding share structure should be considered by members as a separate matter if there is a meeting of members at any stage of the planning for the listing. The share should also be reconsidered no more than 5 years after listing and thereafter at least every 5 years (but subject to the comments below).

How the reconsideration of the provision is structured is a matter for the entity as it is in relation to a shareholder limit, but ASX may regard a special resolution to continue the share's special voting rights as appropriate if the special rights attaching to the share are broader rather than narrower (ie. not merely reserve powers in the event of a change in control).

Of course, the adoption of a structure that allows for reconsideration of the founding share is more complicated than for shareholder limit structures. This is because the passing of the resolution would need to be assessed disregarding any special vote that the founding share carried, but having regard to the interests of the members in the vehicle holding the founding share and the members of the listed entity.

One possibility would be to take a vote in the vehicle holding the founding share, and carrying the proportion of 'for' and 'against' votes through to the listed entity. In other words, the votes of the 'wet' interests (the members in the vehicle holding the founding share) are taken into account in the listed entity as if they were votes of ordinary shares in the listed entity. This gives all 'members' an opportunity to reconsider from time to time if they want to retain the founding share. Another possibility would be to entitle the founding share for this purpose to a number of votes in proportion to the amount of equity held by 'wet' interests at the date of listing. For example, if one quarter of the equity of the listed company was raised externally, and the total issued capital was 100 shares, the founding share would be entitled to a vote equal to 75 shares. Over time, as the amount of outside equity increased the influence of the founding share on the reconsideration would decrease.

The complexity of these sorts of mechanisms may make them impractical in a particular case. ASX would not necessarily regard a structure that did not include reconsideration of the founding share as unacceptable, but ASX may expect the dominant activities to be more rigidly entrenched. For example, there may be a provision that the founding share automatically lost its special voting rights if the vehicle ceased to be a special purpose vehicle.

In assessing requests for waivers, matters that ASX will take into account include whether the purpose of the founding share is to promote co-operative principles, and who owns the founding share.

ASX would normally expect the existence of the founding share to be conditional on the following.

- The special rights attaching to the share must be, in ASX's opinion, appropriate and equitable (eg. reserve powers concerning control issues like changes in the articles, appointment of a number of directors, or takeover matters).

- The founding share must not be transferable (a waiver of listing rule 8.10 may be needed).

- The founding share must be able to be redeemed, or converted to an ordinary share, by the holder at any time.

- Any other conditions that ASX decides are warranted given the structure.

ASX preferred model

The ASX preferred model for listing co-operatives, companies that were co-operatives but have converted to companies, companies limited by guarantee that have operated on co-operative principles, and mutual business entities, has the following features.

- Members of the co-operative or mutual business entity receive shares both in the entity to be listed ("listed entity"), and a holding company for the listed entity ("holding company").

- The listed entity conducts the business of the co-operative or mutual business entity eg a business of bulk grain handling.

- The listed entity has only one class of shares.

- The holding company holds a percentage of the listed company which is acceptable to the members of the co-operative or mutual business entity (eg 50%).

- Ownership of shares in the holding company is restricted to members of the co-operative or mutual business entity (eg active members of a rural co-operative).

- Members of the co-operative or mutual business entity exercise control over the listed entity through a combination of their collective ownership of the holding company, and their individual ownership of shares in the listed entity.

- The holding company is permitted to have "top-up" rights where there is a non-pro rata issue of new securities to enable its current percentage holding to be maintained. Such rights lapse when the percentage holding declines to, eg 20%.

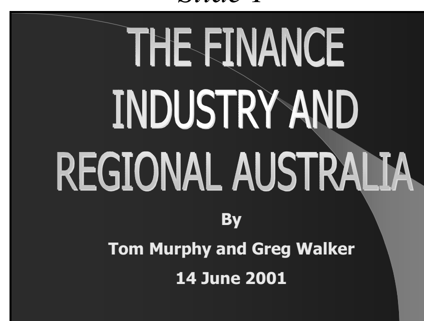
The ASX preferred model enables the members of a co-operative or mutual business entity to retain control of the listed entity in an orthodox way. Influence is exercised through a major holding in the listed entity, in the same fashion that any major holding confers a capacity to exert influence over any other listed entity. Further, the route to a completely normal structure is straightforward, if the holding company permits its percentage holding to decline.♦

4.12 The Rise of Regional Financial Institutions

Mr Tom Murphy, Director, Western Research Institute Ltd

This presentation looks at financial institutions from the perspective of regional communities. It is based on a number of papers written by Associate Professor Greg Walker and myself around the time of the Wallis Inquiry. (Slide 1).

Slide 1



The title for this presentation is The Finance Sector and Regional Australia. The outline of the paper is in Slide 2.

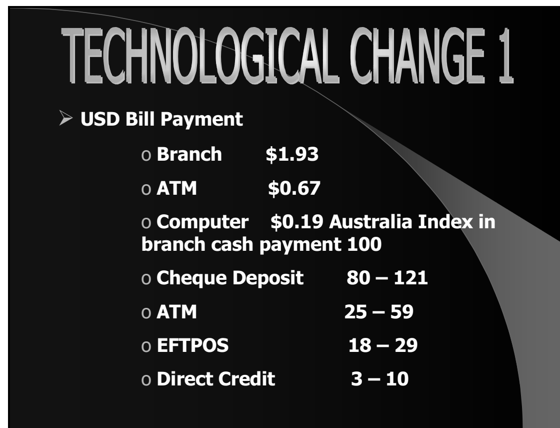
Slide 2

The first point is that the finance sector is important for every other industry sector. This is pointed out by Rizzo. Finance is infrastructure for every industry. Without finance, without a good finance sector, as well as telecommunications and a computer, then industries will not grow; they will not function – finance is a critical part of all industry. (Slide 3)

Slide 3

While finance is a critical part of all industry, KPMG highlights the fact that the only constant in the finance sector is change. So you have a critical part of your economy and it is constantly changing. In the first instance this change is the result of technological change. A lot of people, particularly older people, become very irritated about the banking system's shift away from over-the-counter services. But here, we have some figures from the US – a typical bill payment over a branch counter costs $1.93; the same payment at an ATM costs 67¢; and a computer transaction – an electronic transaction 19¢. A similar type of analysis for Australia, using an index gives a cheque deposit at 80-120, while direct credit is 3-10. (Slide 4)

Slide 4



I think you can see that the cost pressures are certainly to become electronic. It is interesting to note the variability in the figures from the survey for Australia. This suggests that the banks themselves probably are not very clear about the magnitude of these differences.

Technological change does not only change the costs of financial transactions. It also changes the structure of the finance sector. For example, the fastest growing bank in the UK has no ATMs. Other technological changes are increasing, particularly for rural areas. For example, post offices and supermarkets are now part of the banking system. KPMG argue this technological change is two pronged. On the one hand it is reducing the costs of financial transactions. But, on the other hand it is taking away the human contact and the personal aspects of finance. In their submission to the Wallis Enquiry, the National Farmers' Federation reported that its members were clearly reluctant to embrace the electronic alternatives. (Slide 5)

Slide 5

I will now move from technological change to bank closures, I have highlighted changes in my region, which is the Central West. In June '97 the Commonwealth Bank closed at Grenfell, Canowindra and Kandos. The next week Westpac closed in Trangie. The day after the National Australia Bank closed to Trangie, and Kandos. For Trangie there is now no bank at all. (Slide 6)

Slide 6

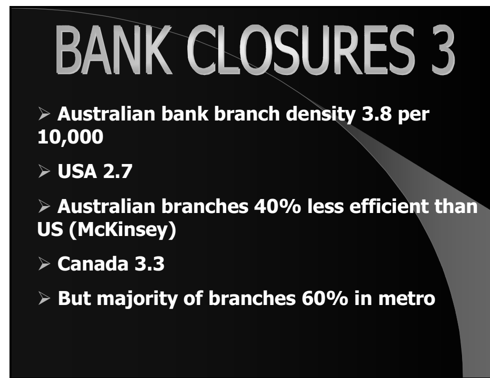
In the Riverina, there were twenty closures in eighteen towns and seven of them lost their financial outlet altogether. The usual process in these bank closures is an announcement two or three weeks before the actual closure – so there is not a lot of warning for the local community. Professor Ralston concluded that the impact of these closures on the local community was "significant indeed" as shown on Slide 7.

Slide 7

She refers to the considerable risk involved in driving with large sums of money over long distances on a regular basis. She also refers to the rise in bad debts, a drop in consumer spending, a reversal of intentions to take out loans and pessimism about the future. These effects are generally felt in towns of less than a thousand. It is the small communities that are most at risk from bank closures.

It could be argued that we need bank closures. The Australian bank branch density of 3.8 is substantially more than the US, and McKenzie estimated that our branches are about forty percent less efficient than their US counterparts, because we have too many of them. (Slide 8)

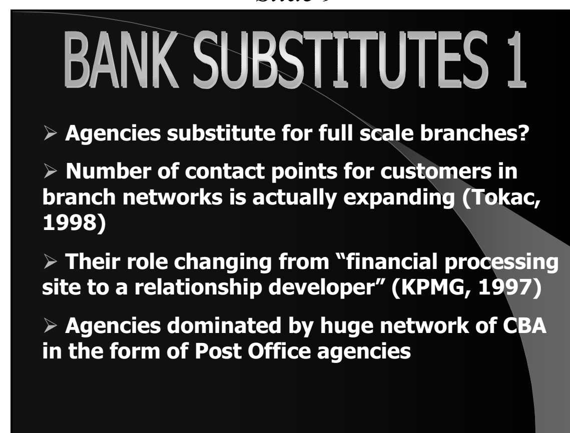
Slide 8



The same types of arguments are used with regard to service stations, where it is argued that too many service stations are the reason for high petrol prices. But, if you compare Australia's bank/population ratio with a more sparsely populated country like Canada, we are not far away from the mark. It could also be argued that since sixty percent of branches are in the metropolitan area that any branch closures shouldn't be confined to regional areas.

Some of the earlier speakers have talked about the rise of bank substitutes and they certainly are emerging. The question is, are these agencies substitutes for full-scale bank branches? Some, such as Tokac have argued that the level of service is improving because there are now more finance contact points – the post office, the supermarket and possibly the chemist and so on. (Slide 9)

Slide 9



KPMG also identified a changing role for the finance industry. This role is a change in emphasis from finance processing to a relationship developer. Finally, mention should be made of the dominance of the CBA network of post office agencies in the smaller communities in rural Australia.

Professor Ralston was going to talk about the rise of credit unions, and they are certainly moving into the gaps that are left by the bank closures. She highlighted thirty credit unions moving into country towns in 1997 and a further thirty moving in elsewhere. (Slide 10)

Slide 10

BANK SUBSTITUTES 2

- Ralston and Beale – credit unions in 30 country towns (1997)
- August 1997, credit unions building societies direct access to cheque clearing system
- Reliance Credit Union Transferred headquarters from Sydney to Bathurst NSW

The extent to which credit unions can be a substitute to banks has been enhanced by credit unions now having direct access to the credit clearing system. Reliance Credit Union recently moved its head office from Sydney to Bathurst and is vigorously filling in the gaps left by banks in regional NSW. It is also competing strongly with the banks. On the negative side, it is generally considered that the credit unions are not experienced in the full range of financial services. Credit unions' may be partial substitutes but they do not provide the full range of financial services previously provided by banks. (Slide 11)

Slide 11

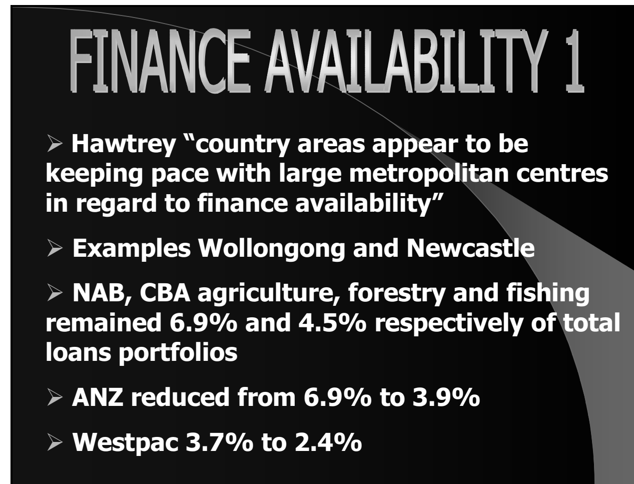
BANK SUBSTITUTES 3

- Credit Union not experienced in full range of financial services
- Not experienced in rural sector farm and business lending
- Same cost pressures as banks electronic versus over counter
- Telecommunication companies potentially strategic position although desire to shed CSO

Specifically, credit unions are not experienced in rural sector farm and business lending. Moreover, it is one thing to say credit unions are returning financial services to the regional areas, but credit unions are under the same electronic costs pressures as are the banks. The fact that it is so much cheaper to conduct transactions electronically as opposed to personal services – filling the gap, left by bank closures in a physical sense by the credit unions would seem unlikely in the longer term. It is worth mentioning telecommunications companies like Telstra could take a key role in providing financial services to rural Australia. With new players in the finance industry there is clearly a possibility of communications companies constituting some of the new entrants. However, Telstra is currently concentrating on limiting its community service obligations.

Hawtrey claims country areas are keeping pace with metropolitan areas with regard to finance availability. But, closer reading of his paper shows that for him regional means Wollongong and Newcastle. (Slide 12)

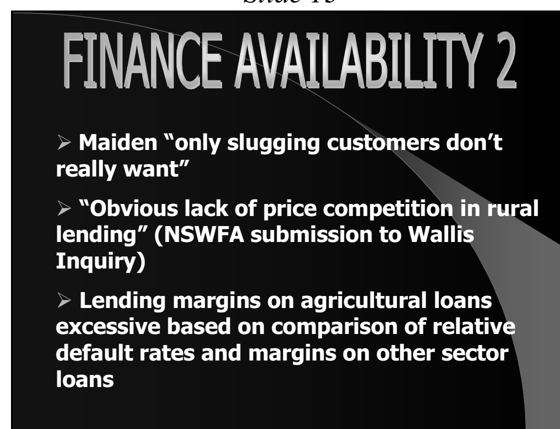
Slide 12



There is no direct evidence that shows whether or not there has been a decline in finance availability in regional areas relative to the cities. However there is data on lending to industries typically associated with rural areas. That is agriculture, forestry and fisheries. The National Australia Bank and Commonwealth Bank ratios for these industries in their total loans portfolios have actually remained fairly constant over the last ten years. However, the ANZ and Westpac have reduced the proportion of agriculture, forestry and fisheries loans in their portfolios.

A frequently mentioned issue is bank fees. It is claimed that regional communities in particular have been the subject of "slugging" of customers that the banks don't want, and it is suggested that regional communities have fitted into this category. The New South Wales Farmers' Federation commented in their Wallis Inquiry submission about an obvious lack of price competition for rural lending and complained that the lending margins for agricultural loans were excessive considering the risk and default rates for the sector. (Slide 13)

Slide 13



In the farming sector, there are sectors that are strong and viable, where debt ratios and interest burdens have fallen. But 80% of farming sector finance comes from loans from banks and the rural sector is a valuable source of deposits for banks. (Slide 14)

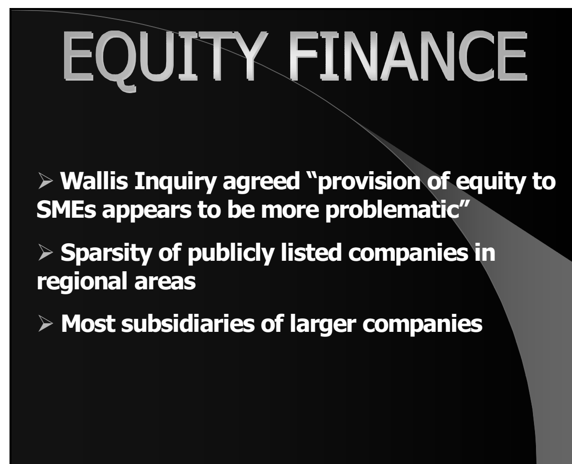
Slide 14

As the banking sector becomes more competitive and drives down the profit margins for city based traditional investment opportunities, the banking sector will look to more rural opportunities to place their investment funds. Many of the more innovative initiatives into new market areas, however, have been implemented by the smaller banks, so it is important then to address the issue of mergers and take-overs. Smaller banks such as Bendigo Bank have often been the leaders in innovative lending to rural industries and so mergers could clearly jeopardise this. (Slide 15)

Slide 15

The Western Research Institute was commissioned to analyse equity investment in rural areas by the Central West Economic Development Board. We found only one publicly listed company based in the central west region. As suggested by the previous speaker its share price rose soon after it listed, subsequently crashed, and rose again when it was taken over. The company complained about the high cost of the prospectus relative to the funds received. Clearly the Western Research Institute study is consistent with pessimistic comments on rural equity by previous speakers. (Slide 16)

Slide 16



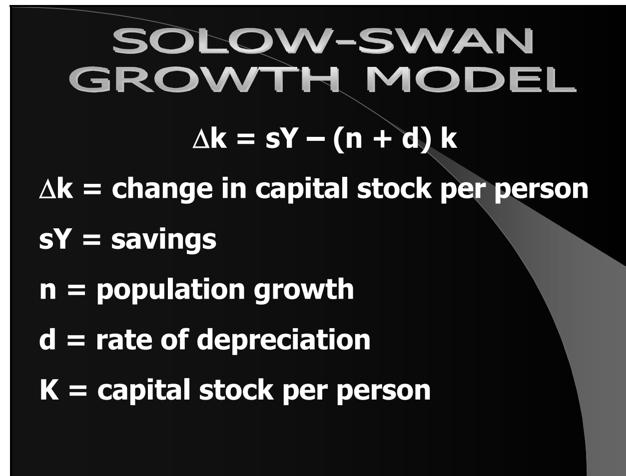
In the US there is the Community Reinvestment Act where financial institutions are monitored for their performance in meeting the needs of their communities. This creates an expanded service. But, on the other hand, it puts a regulatory cost burden on the smaller financial institutions that service regional areas (Slide 17).

Slide 17

I will just very quickly conclude with the Solow-Swan growth model. Solow is a Nobel Prize Laureate. I will take some liberties with his model but will demonstrate the impact on regional communities when the finance sector does not properly serve these communities; Δk is the change in the capital stock per person, which is clearly related to economic growth per capita; sY is savings which can be siphoned off to other regions, or alternatively it is possible to import capital from other regions; n is population growth; d is the depreciation rate which includes depreciation as a consequence of obsolescence. If the financial system doesn't serve a regional community well, then capital stock per person will not increase as rapidly as the economy at large. That is Δk in the region will be below Δk in the rest of the economy. This means that the regional economy has less capital, more obsolete capital, less economic growth and is less competitive. The most obvious way to

increase Δ k and hence competitiveness is to reduce population. To remain competitive population must fall. (Slide 18)

Slide 18



That is, population will leave the regional areas because of the lack of capital. Seventy-five percent of local government areas have lost population in recent years. In other words poor performance by the financial sector in rural areas may be a cause of rural population decline.♦

4.13 Discussion

Chair: Mr David Ginns, Executive Director, Agribusiness Association of Australia

Question: *(Questioner not identified):* Does the US model lead to distortions?

Mr Mailler: The question is whether the US model would cause distortions in much the same ways that tax incentives cause distortions in resource allocation – I guess the answer to that is that given…if you start off from an efficient position in the first place that would be the case, so it would cause distortions and particularly that layer of – one area of efficiency – I think would be the extra administrative efficiency, that is going to be a dead weight loss. But if there is a certain degree of market failure, say there is a distortion of resources in the first place and that that corrects those distortions, to some extent then the loss is not as great. My own position is that I have not looked at it closely enough but it depends upon whether you have got market failure in the first place.

Question: *(From the chair):* Do you think that we have market failure?

Mr Mailler: Ah yes there is a certain – I think there is a lack of understanding of business in regional areas and as a consequence of that – and lack of knowledge, not only understanding. And that automatically we will get a discount on – that people will discount that as an investment – for investment purposes.

Question *(from the Chair):* You talk there about lack of understanding – who is it that is not understanding? Where does the problem lie?

Mr Mailler: The problem lies with the gate keepers for finance – I have had a personal experience of people considering investments in rural areas where there is a natural. It is regarded as soon as it is recognised the investment is in a rural area then there is a concern that this is really a serious investment? So – and I think a large part – some of that I think is because of the lack of understanding about rural investment.

Question *(From the Chair):*But is that (a general lack of understanding about rural business in the investment community) a problem caused by geography or is it the skills and training of the people concerned who are making the decisions? There seems to be a core problem that we are addressing here at the moment?

Mr Mailler: Yes there is – well one of the things is there is a spatial difference. There is also a different industry mix and also I think there is a different "culture", and its also a very thin market. I mean there are some genuine things that are now attractive to investors in regional areas, but there is also an over estimation of some of the problems in many cases.

Question: *Terry Larkin, J T Larkin & Associates:* – I was wanting to ask Michael Hart a question about the structure of the business vehicle. I take it from what you were saying that really most of agriculture and most agribusinesses, either the twenty-five percent in the top or the seventy-five percent below, see the partnership or the discretionary trust as its preferred business vehicle. Should farming organisations themselves and the banking community been stressing this in the development of tax policy? Because it seems to me, from what you were saying, that the borrowers' vehicle of choice in agriculture should have been driving tax policy – not the other way around.

Mr Hart: It is a fact that because of the desire of farming families to keep the principal assets in the family over generations the only way than can do that is via an appropriately set up trust. My point is if they choose that for that purpose, they should not be disadvantaged tax wise in choosing that instead of a partnership. The partnership derives no asset potential, it derives no help at all with each generation of transfers. The other point that I make, and I am one of the farmers, that I have spent most of my life – until the last eleven years I have lived in regional communities…

Question *(from the Chair):*

Mr Hart: That is right – on one hand only. And the fact is that with appropriate tax – after tax results, the regional people will invest in their own communities rather than invest outside of the community. But if you have a system of taxation that is continually pushing hurdles in front of that, they will keep people from doing that. But most of them are very proud of the regional communities and will invest if they have the right after tax result.

Question *(from the Chair):* So in playing off on that point are you really saying that the tax laws at the moment are causing the current flight of people, or flight of people from industries in regional areas and the agglomeration into larger units with fewer - that we are seeing here in Sydney

Mr Hart: I think it would have to be midnight after a few bottles of red for me to be game enough to say that – it is just is not my area of expertise! (laughter) What I am saying that we have to distinguish between private enterprise and public enterprise, and a tax system that suits public enterprise does not necessarily suit private enterprise – you are going to be able to find investment structures to marry the public capital with private ownership, and the best way – the most appropriate way to start is to give people the benefit that should flow from their risk capital. If they lose money in their early years they should be able to benefit from the tax losses in the early years and the only

way to get that is through the "look through" system which comes back to the more privately owned enterprises more than the ordinary partnership.

Question *(from the Chair):* So it is not an issue of treating the agri or regional businesses differently, you see it as an issue of treating public and private differently?

Mr Hart: Well there may well be reasons to treat the two types of business differently, but at the very basis of it I think you need a whole new tax system. Australia has not seen the distinction between private enterprise and public enterprise. The whole tax reform process has been driven by big companies, supported by Treasury and total control taken over by Treasury. Treasury cannot believe their luck in the last few years because they have got everything they wanted. But it has been driven by public enterprise and private enterprise really has not had a say in it. And there is a vast distinction between their capital needs and their taxation needs.♦

5. PANEL DISCUSSION

Chair, Mr Peter Core, Managing Director, Rural Industries Research and Development Corporation

Panelists: Mr Tom Murphy, Director, Western Research Institute, Charles Sturt University, Bathurst; Mr Geoffrey James, Director, Agribusiness, Ernst & Young; Mr Michael Nugent, Director, Westmeath Holdings Pty Ltd; Mr David Bryant, Managing Director, Rural Funds Management Ltd; Dr Terry Dwyer, Visiting Fellow, Australian National University.

Panel Chair: Ladies and gentlemen we might start the concluding session here this afternoon. There are no structured speakers for this closing session but we do have our panel. Our panel is Tom Murphy, whom you have just heard speak, Geoff James from Ernst & Young, Michael Nugent, and David Bryant and Terry Dwyer.

You have obviously had a reasonably big day on the agenda and I won't seek to summarise any of it other than to talk about the issues that have come through the various sessions; the importance of information systems and the quality of information in order to get securitisation off the ground; the impact of tax structures and its effect on different tax structures be they public or private companies; and the role of competition policy and margins. There is a host of issues if one is to look at financing the rural sector and agribusiness operations. I am really in your hands here this afternoon; I am just your Chairman. I now turn the floor over to you people to raise issues and we will get some responses.

Now the first question and if you could just identify yourself as we go along.

Question: *Mr Donald Begbie, Lonsdale Securities:* Mr Chairman I put it to the Panel that there is a significant source of funding to the rural sector which hasn't so far been mentioned today and I am referring to the funds raised under prospectus by the companies that operate under the Managed Investment Act? Some recent calculations that I have done indicate that there are currently about 90 prospectus on issue at the moment, seeking to raise something in the order of $1.4 billion for the rural sector. This as an asset class is unfortunately not well understood or appreciated by the general public but I believe it is doing a valuable service for the rural sector. I'd like to hear the Panel's view on that comment please.

Panel Chair: Thanks for that question, who wants to start it off on the panel?…David Bryant?.

Mr Bryant: Donald I agree with you – perhaps just a bit of background about our company. We currently manage about $70 million with the capital that we've raised ourselves. All of the equity that we have raised has been in non tax effective prospectuses and we purposely made that decision because we felt that some of the tax effective fund raisings were a little bit marginal – where we'd seen – some of – I think well, Don, you'd know more than anybody what some of the costs are that are spent in marketing and administration in some of the offerings, but I suppose some of the offerings are of quite a low quality in fact, but then there are offerings where the quality has been improving over the years. And because of that we've decided that we'll produce a tax effective prospectus within the next twelve months and we'd like to think it will be of very high quality. I think that there is some similarities between the tax effective fund raising industry and the superannuation industry and I think, if you think back ten years, Four Corners was doing big exposés on the superannuation sales industry and noting that there were huge commissions being paid to sales

agents for superannuation funds and the parallels between that and the tax effective industry I think are pretty close, and I think that the tax effective industry with the new regulations that are being brought in as they're constantly upgraded, I think just the quality of the offerings will improve and then they will have to move into the next phase which is where the quality of the operations, the quality of the ongoing management has to improve as well.

That said, there are some good examples where there are – the operational management of tax effective schemes is of a very high standard – I understand, I haven't seen it with my own eyes, but I understand that the forestry industry have some excellent management and perhaps that's why their sales have been so high. So – I think that the tax effective industry has the opportunity to go the same way as the superannuation industry and become quite large and quite respectable.

Panel Chair: Anyone else on the panel want to comment on that? Terry Dwyer?.

Dr Dwyer: When we were giving evidence to the Parliament on the Managed Investments Bill we noted that Sandhurst Trustees also gave evidence and one of the chaps there, and they're from Bendigo and they are associated with Bendigo – he gave evidence to the effect that the requirement to use trustees to manage investment schemes arose from Victorian primary production schemes set up in the early 1950s when they tried to get returned servicemen to put money into forests and so on, but many of those schemes had no independent or external supervision and lots of people lost their money to unscrupulous promoters, so the Victorian Parliament put a requirement in that you had to have an independent trustee to supervise the investment before it could be offered to the public, and this really gets back to the information asymmetry problem we spoke about with banks, ie, people are not willing to put their money into something that (a) they don't know anything about, or (b) they do not have anything certified by somebody who is in the position to know something about it. And information, it seems to me, is this problem, but Sandhurst Trustees made the point that the new managed investment scheme does not allow investors to have the option of an independent trustee to supervise the manager, or keep an eye on him. And they argued that many small rural enterprises, for example vineyards or whatever, which could raise a private prospectus of 3-5 million for which they would be happy to act as trustee, were now going to be rendered illegal by the Managed Investment Scheme, and because the farmer himself could not possibly offer himself to the public as a responsible entity and get himself licensed.

Panel Chair: Well again other members of the panel, does anyone want to make a comment on this issue that Donald Begbie has raised.

Mr Bryant: I was just going to add one more thing which is probably agreeing with what Michael Hart was saying earlier and that is that having a look through taxation structure that didn't involve the – I don't know if it's almost a charade, but the – at the moment, from what I understand, you have to subdivide vineyards, or whatever the proposition is, up into small lots, so you have these 0.6 of a hectare vineyard sizes and so forth. That just seems silly to me. I think that there needs to be some adjustments to the structure so that perhaps a limited liability partnership, such as Michael Hart was suggesting there, could have flow through in the tax deductibility but would be more efficient and probably simpler to administer.

Panel Chair: Thanks David. OK, thanks. There is a question here..

Question: My name is Wal Archer and I was actually going to ask the question that Don Begbie asked, so mine comes really as a supplementary question to that, and David Bryant almost picked it up. Those MIS schemes have raised an enormous amount of money, they've been – it seems to me – reasonably well described in terms of risk on both market and production sides, and I was just wondering whether you saw them as being comfortable with being extended to other industries other than the tree industry where they seem to be concentrated.

Mr Bryant: Well I think so. You have got to look for something that's got a non geared return that allows everyone to have their cut of the cake I suppose. Often – I hope there are no members of the tree industry here - but I have often wonder if one of the reasons that the tree industry is so successful is that the actual investment result isn't reported until fifteen years later and everyone's moved on! But there are some examples where, I mean vineyards are obviously an example, horticultural crops lend themselves to that style of investment product. There is a cotton fund which has been plodding along fairly successfully for quite some few years now – they have an offering out every year and I'm not sure what the investment results are, but I think that if the industry is to mature it's got to be offering investment propositions that pay a return that is competitive to other alternative investments, so then really the tax issue is not important, it's really what is the return that the industry can provide, and so if it is, perhaps, wheat/sheep enterprises – statistically smaller wheat/sheep enterprises seem to be certainly failing to reach ten percent return, and so therefore I don't think, no matter how you dressed that up, I don't think you will find investors wanting to risk large amounts – or lots of investing wanting to risk capital in that sort of enterprise. But when you get to returns of around fifteen percent that seems to me the sort of return that owners of equity are looking for. I once spoke to a very high network investor and complained about the problems we were having raising money and he said 'Well that's simple, you are just not offering me enough for my capital', and so he saw things very simply from the point of view of someone who had capital and wanted a return.

Panel Chair: Right, have we got any other questions out there?

Question: (*Questioner not identified*) David Bryant I just want to ask you, from the all agricultural investments that you've looked at, what would be the average return on those investments?

Mr Bryant: A difficult question. I think the cotton industry can provide returns of fifteen percent. When I quote these returns, these are returns ungeared, so the cotton industry can provide returns of fifteen percent, though you wouldn't want to be trying to sell your crop at the moment because it is close to a twenty year loan. Viticulturists in the Riverland have probably been making returns of almost one hundred percent on capital in the last several years, although that has now changed because grape prices have come down, but good viticulturists would have been making that sort of return on their capital. However, with current grape prices in the - high quality geographic indications – so if you used say Coonawarra or Barossa or that sort of thing, you would be looking for, if you bought a mature vineyard which you can't buy – well there's not a lot of them for sale – you'd be looking for returns of fifteen percent on your capital. If you developed the vineyard yourself you could achieve an internal – I will have to quote an internal rate of return here because you've got the delay in developing it – but you would get a return of seventeen percent internal rate of return. The beef cattle industry, Stanbroke Pastoral Company – before we actually started our company we looked at the returns it had achieved, an Australian agricultural company and a few other companies but Stanbroke Pastoral Company I believe has returned fifteen percent for over ten years – this was four or five years ago when I looked at that. But I would imagine with recent beef prices that it would still be maintaining an average of something like that. I believe that the dairy industry in Victoria, these large scale dairies that have got five thousand cattle and – five thousand cows and one man I heard today – some of them are able to achieve returns of fifteen percent as well I understand, but I don't know that for a fact. Certainly, if you then start to say – look at the top twenty percent of farmers in almost all agricultural industries there are doing better than ten percent, so these are the top twenty percent by performance and by size – size seems to matter. A lot of them are doing better than ten percent and a lot of them are doing fifteen percent. You only have to look at the growth in their net worth over their lifetimes to see that they must be making returns of that. But as an investment analyst, whom I was trying to trot out, our fund raising…he said that the first story he gets when people try to convince him that agriculture is a good bet is that they say...they trot out a return of fifteen percent and then when I pull that to pieces they then say yes, but we're a top

twenty percent producer and then when I pull that apart they then say, but it's good diversification – so he'd seen it all before, I think.

Panel Chair: Any more questions for the panel? Yes, there's a question out the back there.

Question: (*Questioner not identified*). Following on that answer, it does seems as though the top twenty percent can get external financing, which is probably Parato's Law? – but what about the other eighty percent, how do they get financing – do they have to rely on bank finance as they always have? We've heard a lot of options here today, but it does seem that the investor, not surprisingly, wants fifteen percent or better – how do the other eighty percent get on – business as usual?

Mr Nugent: Perhaps I could comment from my experience at Elders in late 1980s and early 1990s, I guess we were servicing virtually all farmers whether they had five bales of wool or five hundred bales of wool and what we found was that our costs were grossly outstripping our revenue growth and we had to restructure our business to focus on the top twenty-five, thirty percent of customers and we really couldn't afford to service in any meaningful way, the lower end of the market, and we did have products for them still, but nevertheless it was difficult in terms of costs of providing that service – and we did have finance accounts with them, we had small finance accounts with them – we had current account where they would buy purchases which would sometimes be finance, but the bulk of our finance product was to the target market of the top twenty-five percent and we found that we go very profitable returns from that – we had earning spreads of somewhere between six and seven percent, we had a long term loss ratio of non-performing loans of about one percent per annum and we found that very – obviously very profitable. The smaller accounts are just hard to deal with because of the plethora of them and I think we had eighty or ninety thousand customers and really probably only twenty thousand of those were important to us. The other sixty thousand were causing a lot of churn, so to speak, and our aim then was to retarget the top end and price as we had to for the bottom end, and I think that is still happening, and I'm not sure where they are getting their finance today, maybe they are getting it still to some degree from the pastoral houses and banks. But a lot of them have other forms of income, a lot of the sub economic farmers are basically – have got off-farm income – they are living there for lifestyle and that's their choice in a sense and I don't know that we really have to moralise over whether we should be providing them the same services that, you know, larger professional, efficient and scale farmers have. I don't know if that answers your question but…somebody else might like to have a go.

Dr Dwyer: I wonder if I could pick that up. Sometimes people get focussed on the idea that before you lend to someone he has to be profitable. But hang on, do the banks ever question whether people living in homes are turning a profit or not? All they care about – I mean they are consumption items, homes, they are not investment items. All the banks care about is the asset security and whether the person can pay. Now for generations in the past London money-lenders have made money from lending to improvident heirs. If some playboy wants to live in the lifestyle choice and can afford to do it, it doesn't mean he is not bankable. So in theory you could actually finance anyone's activity, whether profitable or unprofitable, as long as there is some cash flow you can securely attach and make sure the borrower won't renege on it. At the end of the day you don't care why he is doing what he is doing, or whether it is what you would be in, or whether it is as profitable as other things, you are only concerned about the return to you. The only difference is that if it's a marginal operation you want to be damn sure there is enough external cash going into it, to keep it profitable to you. So in a sense the securitisation or the lending to a borrower does not necessarily depend on the ultimate profitability of the funds. That's just – I'm just putting this in to raise a point for discussion that we need not think that we need to forego the economies of scale in lending to all of agriculture, just because we have to service the top twenty percent. In theory you could, if you could do it efficiently, you could get economies from servicing the whole market.

Panel Chair: All the bankers have just left. But I have got a question there?

Question: *Simon Fritsch, Hassall and Associates*. Working at the coal face with farmers as a consultant to them, when we talk about farm returns and things and I acknowledge that the general run of agricultural producers is running at six or seven percent at best when they are performing well. It seems to me that the millstone is actually land – the amount of assets that they've got tied up on the business. The actual business of farming is very profitable. If we could find someone to take the land off our hands so we could pay them a rent that is reasonable, then we could actually turn it into something that would attract a lot of investment. I'm aware the US system is based very much on rental land and I was just wondering what the panel's comments were on that.

Mr Bryant: Simon here is an example, there is a wine fund listed – wine fund called the Beston Wine Fund where they are leasing – wine companies are typically selling and then leasing back their vineyards - and that's been quite successful and it is actually one of the few agricultural securities that is trading at a premium to NTO at the moment. However they are demanding bonds plus four percent, so you are talking about, say, ten percent and if you got a business returning six or seven well then it is not going to stack up. So the only way that would work is if you sell your farm cheap enough…to get that return. And this is a problem I suppose, as to some extent farmers are a victim of their own success in that they are – they are the people buying the farms at those prices and keeping the land values up – I suppose if we talk with the exclusion of land close to cities – so I don't think things are going to change that much because a lot of farmers are happy enough with that six or seven percent return on their capital.

Panel Chair: Any other response there from the panel. Any other questions out there in this concluding session, yes..

Mr Bryant: Just to add to that, one of the dividends from being a farmer is obviously that your domestic overheads are covered often from within the business, so when there is a six or seven percent return on capital, compared to a salaried person having to pay tax and then buy a house and put fuel in their car and all that sort of thing – I know from my own personal experience, moving from the country to the city – one's personal expenditure has to go up about five times to maintain the same living standard, so that I think that sometimes comparing city…saying farmers are prepared to sit there and accept lower returns on their assets, those assets also include their non performing domestic assets. Which make the whole miserable process worthwhile I think.

Panel Chair: Question?

Dr Dwyer: But this is the point I was trying to make, that is people are doing something, presumably the rewards, both monetary and non monetary, for them doing it are there and if they can continue to do it, although the statistics may not show profitability in one sense, they must be able to finance it so they might be bankable after all. I mean when I look at myself as a self employed person, there was one stage when our income was very precipitously low but we managed to finance ourselves and keep going, and I'm not sure I would have lent myself the money at the time, but I have been richly rewarded by the bank.

Mr James: The only thing of course is that there are two types of agriculture going on isn't there, there is a big sector that occupies a lot of our land mass that is achieving these returns, but there is the horticultural sector and the viticultural sector and areas of irrigated broad scale, broad acres irrigation that are achieving these higher rates of return, so whether or not farmers need to think about moving out of one activity and into another – I suppose that's the process of rationalisation that goes on in industry all the time.

Panel Chair: Tom Murphy?

Mr Murphy: Just a very quick comment. A few years ago we did some estimates of the return on – in the Gwyder Valley - for return on land and also return per megalitre of water and you get quite a

different result, depending upon which one you use as your return. So, particularly with the Water Management Act I think that is probably an interesting one to look at.

Panel Chair: We have got time for a few more questions. Tom Murphy you just had the microphone, if you'd do a bit of thinking – what do you think the shape would be – and I'll go down the Panel - last question and then we will close – what do you think the shape of the financial structure will be for Australian agriculture and agribusiness in five years time? What will be different in five years, as opposed to now?

Mr Murphy: This has been a week for thinking quickly. The – I guess just running through, I think technology is going to be much more electronic, I think there is scope for new products – the biggest change – I think that there's a clear gap in the market which – I don't know whether it can be achieved through perhaps mezzanine type finance of the type Terry Dwyer talked about in the paper he distributed. What else – I think the nature of – there'll be more types of institutions servicing the finance needs of rural Australia.

Panel Chair: What's going to happen Tom when you, say, you've got a hundred and sixty thousand business units out there and let's say fifty thousand of them are not at the quality end, are they on their bike are they? Is the banking sector – is the system not going to be able to cover them?

Mr Murphy: I am not sure whether they are covering them well at the moment. One issue that was raised, particularly in Terry Dwyer's paper is moral hazard. I think it fits into both farmers and all small business. You can - particularly in a rural context get yourself locked into a business that is worth nothing, you have had to keep working and quite often have to work enormously long hours and enormously hard, simply because you have got no scope for either adjusting. Those people have got no way of building capital, or changing their business – so they get locked in. Also that bottom eighty percent I think is an interesting insight of Michael Nugent – particularly about it was only really viable to service the top twenty percent of farms. I think there are quite a lot of people who get locked into that eighty percent. Without capital coming in to change their circumstances they are in a fairly difficult situation.

Panel Chair: Thanks Tom Murphy. Geoff is there anything you'd like to say in terms of looking down five years on this agenda?

Mr James: I think technology is certainly going to drive a more informed market. E-commerce has got to play a real part. I think government initiatives and moving towards bettering access to those services. Most growers are going to improve risk management of crops. I would hope that the superannuation industry are going to see a way of investing in Australian agriculture. I think within that five year period we are going to see less of sons and daughters wanting to go on the farm and that's going to create opportunities for the superannuation industry to get into that market. Hopefully with some more skills by these people who are putting investment packages together, rather than the tax purveyors who have existed up to date, rural industry will get a better image and people will be prepared to invest in equity in Australian agriculture and agribusiness.

Panel Chair: Thanks Geoff James. What about you Michael?

Mr Nugent: I think we will see a further concentration at the top end – I think there will be, as Geoff said, that - you know - the successors won't necessarily want to continue with their families' properties. I think the agglomeration of properties that has gone on for quite some years now, that will continue. I think certainly that technology will play a big part. I think there is margin enough in rural lending for a greater range of products to be offered for securitisation to be done so more funds can be made available – it is already being done in some cases and I think that there is scope for that to occur. I think that one of the speakers from Macquarie Bank said it was difficult for the banks to

do. But I think some of the other smaller institutions and pastoral houses, and so on, will probably look at that avenue to offer a greater range of products to the growing top end of the market.

Panel Chair: Your turn David.

Mr Bryant: I agree with the comments so far. I think just like the wine sector that we've seen very recently and the retail sector, there will be the continuing aggregation of assets. Farms will be getting bigger and farms will be getting corporate in a lot of instances as well. Although as there is now, there will continue to be many large private farmers who continue to prosper and get bigger. I think that there will be some similarities, hopefully for the sake of our business, there will be some similarities to the property trust industry where institutions never got into listed property trusts until retail investors had really got the industry up and running – the institutions came in a second wave once they realised that this was a viable and serious sector. And that's probably the same with casinos and other emerging sectors that are listed on the Stock Exchange. So I think that our business strategy is to concentrate on retail investors and I hope that in five years time that we will have so many retail investors making good returns that the institutions might finally decide that it's not going to be damaging to their career to have a bit of a go at it as well. And I think that that will actually throw up opportunities for employment in the agricultural sector which does not entail land ownership and it will be where there are farmers – tertiary qualified farmers running those farms maybe along the Harvey Norman model where they have an incentive, or they are contracting or subcontracting - the people in the Harvey Norman shops don't actually own the shop but they own the little business, or the enterprise that's in that shopping centre. I think that – I mean there are actually examples of that in the cotton industry already and I think the viticultural industry will lend itself to that as well, where there'll be farmers who are contracting to manage these properties but have a very substantial incentive package in their remuneration which will be based on yield and financial performance and so on. So I think that will be a big opportunities for employment in agriculture in the future.

Dr Dwyer: As I indicated earlier in the Issues Paper, I think it is going to come down to a question of the good old scissors of supply and demand. You've got a huge volume of institutional money both here and overseas and pension funds, looking to be invested. Even as a small investor, if you look at investing in Australia and you want to keep your assets in Aussie dollars to offset anticipated Aussie dollar liabilities, you have to look across all sectors. Now you can invest in Australia's resource industries, you can buy mines and so on, but you can't buy farms. So there is on the one hand an interest in people getting exposure to agricultural cycles and on the other hand there is a sector that is seeing that it needs to get bigger, to be more competitive, and a gap opening up between what banks can prudently and what the owners can necessarily put in. I can see, for example, that suggestion about land – I can see for example you getting land separated from farming just the way you've seen land separated from retailing with companies like David Jones selling their land assets – wisely or unwisely is not the point financially, but basically you are seeing people who are saying our job is a retailer, not a landholder. I can see basically all sorts of things entering into public securities markets because at the end of the day the money is going to be with institutional fund managers and pension fund investors who want tradeable securities, whether debt securities or equity securities or hybrids, they are going to be looking at that. The banks will not be able to hang on to the provision of credit to the rural sector. I suppose I can give an example of this – I have been out in the South Pacific recently and people think there is no money to be had in the South Pacific economies – well the ANZ bank in Samoa, I think, offers three and a half percent to its depositors and charges ten to eleven to its business borrowers. That's a pretty wide spread. So the financial sector as I understand it in Australia is not quite as good as that but there is fat in the margins – there is money to be had from lending to profitable rural borrowers. But those borrowers are going to say, well hang on..I want to lower my cost of finance, I want to look for other opportunities. So on both the demand and the supply side I can see trends towards more commercialisation of rural finance.

Panel Chair: Thanks Terry. Now we've just had a little run through and it's about twenty past four – has anyone else got any views about the shape in the future?

Question: *Sandy McEachern, Agribuys Australia*: This is not a view but more of a question to the panel again. Given some of the fundamental drivers of, say, the evolution of the food industry being identity preservation, quality assurance and traceability, and then some enabling technologies like the Internet to allow people in the middle of the chain to manage the network, if you like, from say the farm to the retail outlet, where is the finance industry's minds up to in terms of channelling finance through those network managers in the future?

Panel Chair: Do you want to have a go Geoff James?

Mr James: I don't know. There is no doubt there is a fair bit of activity there in terms of Internet banking and loan applications etc. from the banks to the borrowers, that is starting to answer the question to you. The banks generally are using, far more, facilitators who are more commercial people to arrange loans in the bush. I think that is improving the quality of the loan transactions for the bank and carries the bit of risk for the facilitator in terms of his commission. I suppose in some way the bank's addressing their lack of branch network in doing that, but they are certainly getting better quality loan applications and being able to provide better quality service through those types of facilities.

Panel Chair: What about you David – your funds management, is it basically a production focus thing or does it go back to the question just asked which is basically chain funding? Essentially, where are you on chain funding?

Mr Bryant: I am not sure I understand what it is. I will answer the question in a different way I suppose and that is that the industries that are subject to these quality assurance programs and traceability programs and so forth at this stage tend to be the horticultural industries as I understand it, and those are the industries that offer the greatest potential returns. I think one of the speakers today asked the question 'where was the next viticultural industry or wine industry going to be?', and I think it is likely that some of the horticultural industries will be as successful as the wine industry – I suppose wine at the end of the day is just another packaged food. And the wine industry has played off Brand Australia very successfully and I imagine, or I believe that that will occur more in the horticultural produce as well, particularly as this sector expands. And so at the moment most of the players in the horticultural industry are non-corporate, but I believe that that sector offers sufficiently high rates of return on equity to attract corporate investment and it will probably come from, or is already starting to come from the tax effective investment sector. There are managed investment schemes in some of the horticultural industries already and I would expect that that will continue to develop and expand.

Panel Chair: Are there any other participants in here just wanting to make any concluding comments before we wrap up?

May I now move an official vote of thanks to the Panel, and to all of our Speakers and participants in this Conference. The Papers and Proceedings of today's Conference will be put together in a RIRDC Report which we will aim to send to all participants as soon as possible.♦

APPENDIX 1

CONFERENCE AGENDA, BIOGRAPHICAL NOTES AND ATTENDANCE LIST

AGRIBUSINESS ASSOCIATION OF AUSTRALIA

CEDA

RIRDC RURAL INDUSTRIES RESEARCH & DEVELOPMENT CORPORATION

EFFICIENT EQUITY AND CREDIT FINANCING FOR THE RURAL SECTOR

NEW DIRECTIONS IN RURAL AND AGRIBUSINESS FINANCE

Thursday, 14 June 2001, 9.30am for 10.00am to 4.30pm
State & Regional Development Conference Centre, Level 44, 225 George Street, Sydney

Issues & Conference Structure
DR TERRY DWYER
Visiting Fellow, Australian National University

Opening Address
Senator the Hon JUDITH TROETH MP
Parliamentary Secretary to the Minister for Agriculture, Fisheries and Forestry

Future Growth Directions in Australian Agriculture
IAN DONGES
President, National Farmers' Federation

Evolution of the Australian Financial System
Prof WARREN HOGAN
Director, Westpac Banking Corporation

Problems and Challenges of Rural Finance
BRUCE BROWN
Shortly to join Queensland Cotton as General Manager, Strategy

Securitisation of Australian Agriculture : How can it be advanced?
ROBERT HARRIS
Division Director, Debt Markets, Macquarie Bank Limited

MICHAEL CULLEN
Executive Director, Regional Development
Department of State & Regional Development

Business in Challenging Times
KELVIN THOMSON MP
Shadow Assistant Treasurer

Taxation and Superannuation Obstacles to Rural Investment
MICHAEL HART
Partner, Cleary Hoare Solicitors

Equity Finance & ASX requirements
RUSSELL MAILLER
National Business Development Manager - Companies, Australian Stock Exchange

The Rise of Regional Financial Institutions
DR DEBORAH RALSTON
Professor of Finance and Dean, Faculty of Business, University of the Sunshine Coast

DAVID GINNS
Executive Director
Agribusiness Association of Australia

Panel Discussion – ***New Directions in Rural and Agribusiness Finance***

Chair : PETER CORE, Managing Director, Rural Industries Research and Development Corporation
TOM MURPHY, Chief Executive Officer, Western Research Institute, Charles Sturt University, GEOFFREY JAMES, Director Agribusiness, Ernst & Young, MICHAEL NUGENT, Director, Westmeath Holdings, DAVID BRYANT, Managing Director, Rural Funds Management Ltd, DR TERRY DWYER, Visiting Fellow, Australian National University

CEDA thanks the Department of State & Regional Development for the use of their premises

CEDA - the Committee for Economic Development of Australia - is a non-profit, independent, and apolitical association of business, academic and other leaders, providing an unrivalled range and mix of forums for dispassionate discussion and learning about Australian economic and social development issues. Also integral to CEDA is a well respected stream of independent research studies and regular publications.

CEDA is a communications link between business, government, unions, academia, and other groups. Its members gain knowledge about Australian and international economic, social and political trends, and participate in exchanges on policy issues. Conditions and prospects in various industry sectors, as well as the general local and overseas economies, are dealt with.

CEDA's Trustee coverage extends to all States and Territories in Australia, and its international linkages include counterpart associations in nine European countries (including Britain); eleven Asian nations; New Zealand and the United States.

CEDA's research is conducted by independent acknowledged experts, and its journals, Growth, PEN, and the CEDA Bulletin, frequently carry the opinions and contributions of Trustees and conference program presenters. CEDA's research findings have directly influenced the policy of governments of different persuasions at both Federal and State levels. CEDA has been referred to as one of Australia's pre-eminent think tanks.

- Please turn off mobiles at all times during the sessions
- Please ensure the security of your personal belongings at all times – no responsibility for loss or theft can be assumed by the Department of State and Regional Development

PROGRAMME

9.30am	*Registration*
10.00am	Welcome and Introduction **JIM GALE** Executive Director CEDA
10.05am	**MICHAEL CULLEN** Executive Director, Regional Development Department of State & Regional Development
10.15am	Issues & Conference Structure **DR TERRY DWYER** Visiting Fellow Australian National University, Canberra
10.20am	Opening Address **SEN THE HON JUDITH TROETH MP** Parliamentary Secretary to the Minister For Agriculture, Fisheries and Forestry
10.35am	Future Growth Directions in Australian Agriculture **IAN DONGES** President National Farmers' Federation, Canberra
10.50am	Evolution of the Australian Financial System **PROFESSOR WARREN HOGAN** Director Westpac Banking Corporation
11.05am	Discussion
11.20am	*Morning Tea*
11.55am	Problems and Challenges in Rural Finance **BRUCE BROWN** Shortly to join Queensland Cotton as General Manager, Strategy
12.15pm	Securitisation of Australian Agriculture : How can it be advanced **ROBERT HARRIS** Division Director, Debt Markets Macquarie Bank Limited

12.35pm	Business in Challenging Times **KELVIN THOMSON MP** Shadow Assistant Treasurer
12.55pm	Discussion
1.10pm	Buffet Lunch
1.55pm	Introduction by Chair **DAVID GINNS** Executive Director Agribusiness Association of Australia
2.00pm	Taxation and Superannuation Obstacles to Rural Investment **MICHAEL HART** Partner Cleary Hoare Solicitors, Brisbane
2.20pm	Equity Finance and ASX requirements **RUSSELL MAILLER** National Business Development Manager – Companies Australian Stock Exchange Limited
2.40pm	The Rise of Regional Financial Institutions **DR DEBORAH RALSTON** * Professor of Finance and Dean, Faculty of Business University of the Sunshine Coast, Queensland
3.00pm	Discussion
3.15pm	Afternoon Tea
3.30pm	Panel Discussion *Chair:* **PETER CORE**, Managing Director, Rural Industries Research and Development Corporation *Participants:* **TOM MURPHY**, Chief Executive Officer, Western Research Institute, Charles Sturt University, Bathurst; **GEOFFREY JAMES,** Director, Agribusiness, Ernst & Young; **MICHAEL NUGENT**, Director, Westmeath Holdings; **DAVID BRYANT**, Managing Director, Rural Funds Management Ltd; **DR TERRY DWYER**, Visiting Fellow, Australian National University.
4.28pm	Vote of Thanks
4.30pm	Close

* **Note:** Mr Tom Murphy replaced Professor Ralston who was unable to attend.

BACKGROUND INFORMATION

BRUCE BROWN is shortly to join Queensland Cotton as General Manager, Strategy. He has some twenty years' experience in the provision of financial services to the agribusiness sector, having been employed in senior executive roles with NZI Securities, Elders, Commonwealth Development Bank, ANZ Banking Group and until recently, AWB Ltd.

Previously, Mr Brown was a lobbyist with NSW Farmers and lectured in agricultural economics/farm management at Roseworthy and Orange Agricultural Colleges and at the University of New England.

He has expertise in profit centre and agribusiness loan portfolio risk management, strategic planning/policy development, industry analysis and lobbying. In addition, he has assessed agribusiness profitability/investment at both the industry and individual business levels.

Mr Brown has represented the banking/finance industry as Chairman of the Australian Bankers' Association Rural Committee and at a variety of ministerial round tables. He was a member of the Victorian Wool Industry Taskforce in 1996 and is currently a member of the National Rural Advisory Council.

Mr Brown is a graduate (hons) from Wagga Agricultural College and the University of New England.

DAVID BRYANT CFP, Dip FP - Managing Director Rural Funds Management Ltd. David established Rural Funds Management Ltd in February 1997 and has managed the acquisition and development of over $70 million in farm assets. This included the acquisition of nine properties, the sourcing, acquisition and transfer of significant water rights, recruitment and direction of senior farm personnel and the design and implementation of farm development plans and product marketing strategies.

He has been advising on superannuation investments since 1983 and previously authored a weekly column in the national Australian press on financial planning. Mr Bryant has a Diploma of Financial Planning from Royal Melbourne Institute of Technology and is a Certified Financial Planner. Mr Bryant is also a director of Murrumbidgee Farming Ltd and Lachlan Farming Ltd.

PETER CORE is the Managing Director of the Rural Industries Research and Development Corporation, a position he has held since May 1996.

He holds a Master of Economics and Bachelor of Rural Science from the University of New England. Prior to 1996, he held senior positions in the Commonwealth Government, primarily in the agricultural related portfolios.

MICHAEL CULLEN is currently the Executive Director, Regional Development Division, NSW Department of State and Regional Development. Michael has extensive experience in the field of regional development practice and policy and manages the Department's regional office network across New South Wales (18 offices).

Key activities of Regional Development Division include :

- Helps potential investors to identify and develop commercial opportunities in regional NSW;

- Assists businesses which want to relocate to the State's regions;

- Assists regionally-based firms to expand their business and find new markets;

- Helps firms diversify and add value to products to capitalise on alternative industry opportunities;

- Assists regions develop as viable economic locations with strong regional leadership and strategic directions;

- Helps regional communities to recruit more industries, unite interest groups and develop region-wide action plans.

IAN DONGES was elected President of the National Farmers' Federation in May 1998. He was previously Vice President of the NFF and President of the New South Wales Farmers' Association.

Mr Donges has represented the National Farmers' Federation on a national and international level. He attended the Annual Conference of the International Federation of Agricultural Producers in Manila, Philippines, in June 1998, the International Women in Agriculture Conference in Washington, USA, in early July 1998, and led a delegation of the Cairns Group Farm Leaders to the WTO in Geneva in October 2000.

DR TERRY DWYER conducts an economic and taxation consultancy practice in Canberra providing consulting and advisory services to Australia and international clients. Prior to establishing his firm with Deborah Royal Dwyer, LLB, in January 1989, Dr Dwyer was a senior Federal government official where he spent many years in taxation, economic and social policy advising, research and administration. His appointments included those of Senior Research Officer, Australian Bureau of Statistics; Senior Finance Officer, Tax Policy Branch, Commonwealth Treasury; Senior Adviser, Taxation and Income Security Section, Economic Division, Department of the Prime Minister and Cabinet; and Senior Adviser, Office of the Economic Planning Advisory Council. He has served as Private Secretary to a Senator.

Dr Dwyer has been involved as an adviser and analyst in a wide range of taxation and public expenditure issues throughout the 1980s and has published several books and articles on taxation and economic issues. In association with the firm JT Larkin and Associates, his firm has also provided advice to major corporates on the quantitative implications of the GST package for bottom line profitability. A co-authored article "The GST Package : Getting to the Bottom Line" was published in the *Australian Tax Review* in December 1992.

DAVID GINNS, Executive Director, Agribusiness Association of Australia. David hails from the Hunter Valley via the South West Slopes, Sydney and the NSW Central Coast.

He attended Hawkesbury in the early eighties, gaining a Bachelor of Applied Science in Agricultural Systems. In 1993 he returned to Hawkesbury to complete a Master of Marketing and Commerce in that year - while working part time as a course tutor.

David has worked in a diverse range of positions including as a storeman, forklift driver, mechanic, farm labourer, agronomic assistant, gardener, cleaner, marketing assistant – and has worked in the dairy, beef cattle, feed milling, flour milling and salt industries, as well as in political lobbying and latterly in what is rapidly becoming an IT role.

ROBERT HARRIS is Division Director, Debt Markets at Macquarie Bank Limited is responsible for the origination, structuring and execution of asset backed transactions. Robert has more than 12 years experience of completing asset backed transactions in the capital markets in Australia, SE Asia and Europe. Prior to moving to Australia five years ago, Robert was legal counsel in England for issuers and banks before becoming an investment banker in London.

He has experience of securitising mortgages, leases, trade receivables, personal loans, auto loans and infrastructure and currently specialises in applying credit derivatives in asset backed transactions and using structured debt for emerging asset classes eg commodities.

MICHAEL HART, is Partner, Cleary Hoare Solicitors Brisbane. He has been a solicitor for over 30 years and has practised extensively in taxation areas, including business and development structures, capital gains tax, stamp duty, estate planning and superannuation.

In addition to those areas of special experience, Michael has a broad range of legal and commercial experience in many areas of law and commerce. Tax planning and estate planning, superannuation, stamp duty and related areas have, for many years, comprised virtually 100% of his work. He is a frequent presenter of seminars for CPA Australia and other bodies.

GEOFFREY JAMES Director, Agribusiness, Ernst & Young.

Geoffrey's career in the professional accounting area spans in excess of 32 years, 28 years as a principal, and has led from general practice to the provision of general management consulting advice to corporations at all levels. Geoff acts as the Director of Agribusiness – nationally for Ernst & Young.

Geoff's entire professional career has been primarily directed towards agribusiness in the provision of management and consulting services and the development of alternative strategies to maximise the profitability of companies. He also serves on boards of companies and industry associations. He currently holds the office of National President of the Agribusiness Association of Australia and in that role he joins us today in the panel discussion.

RUSSELL MAILLER is the National Business Development Manager - Companies at the Australian Stock Exchange Limited. As part of this role, Russell is responsible for companies considering listing on ASX and assisting them through the IPO process. He is also responsible for managing the commercial relationships with existing listed entities.

Prior to working at ASX, Russell has worked as a private client stockbroker, corporate advisor and fund manager

TOM MURPHY is currently Chief Executive Officer of the Western Research Institute, Charles Sturt University, Bathurst. He holds the degrees of Bachelor of Economics with First Class Honours from the University of New England and Master of Science (Economics) from the University of Lancaster.

Mr Murphy has previously held academic positions as senior lecturer in Economics; Director of the Regional Economics Research Unit in the Faculty of Commerce, Charles Sturt University, Bathurst; and positions at the University of New England and Macquarie University. He has also held the positions of Economic Analyst with the Office of National Assessments in Canberra, with responsibility for the ASEAN economies and Senior Consultant with KPMG Peat Marwick Management Consultants.

MICHAEL NUGENT is Director, Westmeath Holdings Pty Ltd. Michael has extensive experience at a senior level in food and agribusiness industries. He was formerly the Chief Executive Officer of Goodman Fielder Limited and the Managing Director of Elders Agribusiness. Both of these roles required considerable understanding of farmers, rural activities and the flow of farm products through to end markets. It also required a full understanding of the risks associated with it, particularly that of financial risk, in conducting business in the sector. In addition he was directly responsible for the activities of Elders Pastoral including its rural finance operation.

He has also held a number of directorships of public companies including: Rail Access Corporation, Snowy Mountains Engineering Corporation Limited, J Boag &

Sons Limited, Goodman Fielder Limited, National Commercial Union Limited and Fosters Brewing Group Limited (formerly Elders IXL Limited).

DR DEBORAH RALSTON is Professor of Finance and Dean of the Faculty of Business at the University of the Sunshine Coast. Her research includes topics concerned with bank regulation and performance, regional banking and regional economic development. She has published extensively in these areas. Prior to joining USC, Deborah was the founding Director of the Centre for Australian Financial Institutions since 1996. She is a Fellow of the Australian Institute of Banking and Finance, the Australian Institute of Management, and CPA Australia. Deborah is a regular media commentator and invited speaker on banking issues at finance industry conferences. She has been a Director of Heritage Building Society since 1992.

KELVIN THOMSON MP, Member for Wills, Shadow Assistant Treasurer.

Kelvin has been the Member for Wills in Victoria since the 1996 election and was promoted to the roles of Parliamentary Secretary to the Shadow Treasurer and to the Shadow Minister for Population and Immigration in 1997 and to the Shadow Ministry as Shadow Assistant Treasurer after the 1998 election. Kelvin is currently chairing the ALP's BAS Inquiry. Prior to joining Federal Parliament, Kelvin was the MLA for Pascoe Vale in the Victorian parliament from 1988 to 1995.

SEN THE HON JUDITH TROETH MP has been a Liberal Senator for Victoria since 1993. In 1997 she was appointed Parliamentary Secretary to the then Minister for Primary Industries and Energy. She has continued in this position for the past three years as part of the Howard Government ministry.

As Parliamentary Secretary, Senator Troeth has portfolio responsibility for horticulture, agricultural and veterinary chemicals, agricultural research and development and levies. She is the Chair of the Agricultural Finance Forum and assists the Minister in a number of other areas within the portfolio. She also has responsibility for the passage of all of *Agriculture, Fisheries and Forestry – Australia's* legislation in the Senate.

Among her achievements in this role, Senator Troeth lists the establishment of Horticulture Australia Limited, which has brought 28 separate horticultural industries under one umbrella; a substantial increase in the number of women being appointed to the Government's boards and committees; greater recognition of the horticultural industry in rural Australia and the contribution it makes to regional economies; implementing a set of guidelines for levy applications; and ensuring the smooth passage of major pieces of legislation through the Senate, such as the bills to establish Meat and Livestock Australia, the deregulation of the dairy industry, the privatisation of the wool stockpile and the Australian Wheat Board.

GUEST LIST

Chris Ambler	Researcher Department of Foreign Affairs & Trade
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Tom Blayney	Senior Analyst Australia and New Zealand Banking Group Limited
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Stephen Carroll	Director Australian Bankers' Association
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David Foung	General Manager, Finance & Administration Ruralco Limited
Simon Fritsch	Senior Consultant Hassall & Associates
Jim Gale	Executive Director CEDA
John Gardner	Senior Lecturer Agribusiness Management Massey University, Institute of Natural Resources
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David Harris	Managing Director Agripartners Pty Ltd
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Barry John	Partner Kalinga Farms
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	Bob Lim & Co
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Sandy McEachern	Agribuys Australia
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Glenn McTaggart	Managing Director Marketing Edge Agriculture Services
Nick Milham	Program Leader Industry Policy NSW Agriculture
Sean Miller	Senior Manager National Australia Bank
Greg Mole	Senior Associate Minter Ellison
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Nandhini Nagaratnam	Department of Agriculture Fisheries & Forestry
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Mathieu Thomas	Agribuys Australia
David Timmel	Chief Manager - Northern Commercial Banking BankWest
Jeremy Townsend	Group Commercial Manager

	Ricegrowers Co-Operative Limited
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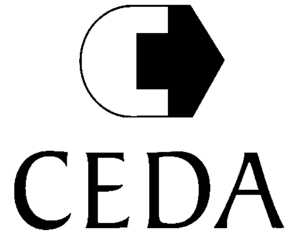
Catriona Wyatt	Conference Director CEDA



APPENDIX 2

EFFICIENT EQUITY AND CREDIT FINANCING FOR THE RURAL SECTOR

NEW DIRECTIONS IN RURAL AND AGRIBUSINESS FINANCE

Thursday, 14 June 2001, 9.30am for 10.00am to 4.30pm
State & Regional Development Conference Centre,
Level 44, 225 George Street, Sydney

ISSUES PAPER

by

Dr T M Dwyer, Visiting Fellow, Asia-Pacific School of Economics and Management, Australian National University and R K H Lim,
Bob Lim & Co Pty Ltd, Economic & Policy Consultants

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As Australia's rural industries in 2001 move into a new era of prosperity, and with agribusiness increasing in scope, a unique opportunity arises for the sophisticated and highly internationalised Australian financial sector to integrate more efficiently with Australian agriculture. More effective integration would result in productivity gains and further enhance Australia's international competitiveness. A number of important technical matters arise in this context however. It is to these issues that this Paper is addressed.

Background

The central economic problem for any country is to maximise the long-term income generated by its land, labour and capital. Australia is a country rich in natural resources and the history of its development and growth is a history of financing and developing agricultural and pastoral enterprise. In the 19th century, there was considerable interest in innovations such as stock mortgages and Torrens title land registries precisely because colonial legislators wanted to remove barriers to the efficient financing of agricultural and pastoral activities.

Economic growth and efficient financing are inter-related

In Australia's postwar years, governments sometimes consciously directed the flow of credit towards primary industry activities and development banking was consciously fostered to promote primary industry. The Rural Credits Department of the Reserve Bank, the Commonwealth Development Bank, the Primary Industry Bank and the Australian Industry Development Corporation grew out of a conviction that conventional credit financing was inadequate for the needs of primary producers.

However, credit subsidies or credit direction may distort capital flows to the detriment of overall national output as the Campbell Committee recognised. So, just as the 30/20 rule for superannuation funds has passed into history, so have specialist semi-governmental development finance banks. Since financial deregulation in the 1980s, former implicit subsidies for rural industry credit such as bank foreign exchange profits and Reserve Bank credit guidelines have disappeared and even transaction banking is becoming more difficult for many rural customers. The days of controlled credit flows to agriculture at low and stable interest rates are gone.

The days of directed credit to agriculture are gone

In addition controls on the use of self-managed super funds have limited the extent to which self-financing is possible. This has become more important as financial flows have changed. Superannuation funds, favoured by compulsory contributions and a better tax position have increased their share of household savings. The long era of inflation favoured investment in ordinary shares

over bank term deposits. There has been increased direct investment by households and through managed funds in the stock market. The changed flows of funds through non-bank institutions such as superannuation funds and the declining share of banks in intermediating the flow of funds from savers/investors to borrowers/enterprises has had implications for financing primary producers. There are competitive pressures on banks to change service patterns and banks are not, and cannot be, suppliers of equity capital or investors in listed securities. Unlike banks, superannuation funds and managed funds are not generally providers of finance to the rural sector. Portfolio managers cannot invest in farm enterprises through the ASX.

But the rural sector's access to state-of-the-art financial instruments is limited

Meanwhile increasing restrictions on equity securities offerings have limited the farm sector's access to risk capital. The Managed Investments Act does not make it easy for farmers to diversify ownership risk and there have been claims that it is harder for rural businesses to raise equity capital through collective investments such as unit trusts. It has also been suggested that uncertainty over the application of tax legislation to losses on rural investments has dissuaded genuine investors from supporting the development of new agricultural technologies through collective investment schemes. In addition venture capital is dissuaded by the Australian taxation climate. The question needs to be addressed whether there are regulatory impediments to the flow of funds to the rural sector which impinge on it disproportionately.

Australian agribusiness on the threshold of a new era of growth?

This is an important question because Australian primary industry may be about to experience large favourable movements in its external environment. The eruption of mad cow disease and foot and mouth disease in the European Union together with Europe's long-term fiscal problems is calling into question the wisdom of its farm subsidies. At the same time, with at times depressing slowness and backsliding, there has been some progress towards liberalisation of agricultural trade.

Capital flows changing in a new domestic and international framework

Far away from the land, in major financial centres such as New York, Chicago, London, Tokyo, Hong Kong and Singapore the globalisation of financial flows has implications for financing Australian primary industry. When it comes to attracting finance, Australian farmers and pastoralists are not simply in competition with Australian homebuyers but with oilfields in the Arctic, palm oil plantations in Malaysia, software companies in California and millions of other commercial, industrial or primary production activities. Australian superannuation funds, managed funds and individual investors look increasingly to place their investments in a global marketplace. Conversely, overseas investors are as important as they ever were for financing Australia's development. Not since the 1914, has the world financial system been as open to

transnational flows of funds. While some may fear the alleged loss of national sovereignty, the emergence of large pools of capital (partly associated with rising pension fund savings in ageing OECD economies) looking for safe and reasonable investment regimes is an opportunity for countries such as Australia with well-developed and stable legal and public administration systems.

Unique features of agribusiness

In these circumstances, it is important that Australian primary industry have the opportunity to be as efficient as possible through access to the widest possible range of financing instruments. In development economics, the efficient financing of the agricultural sector is properly seen as a key to raising productivity and competitiveness. What is sometimes forgotten is that for developed agricultural countries such as Australia and the USA, efficient financing of the rural sector remains a key to ensuring that they make the most of their natural resource endowments and retain international competitiveness. The skill with which its primary production industries are financed is just as much a component of Australia's comparative advantage in agricultural trade as the sun, the soil or the rains - and skill in managing the liability structure of agribusinesses can compensate for the occasional adverse development in the natural environment.

Rural and agribusiness financing is not just a question of bank or debt finance. Equity financial flows have to be considered and also the role of equity investing institutions such as superannuation funds (including self-managed superannuation funds) and the flow of funds through the stock market

Equity finance crucial for Australian agribusiness

Traditionally, Australian primary industry has been characterised by small businesses (often controlled or managed within a family or family group) which supply the equity and banks and pastoral finance houses supplying debt finance.

Agriculture is a high capital-intensive industry and small changes in the cost of credit can have a major impact on net profits. Profits are also variable and excessive reliance on debt rather than equity finance can result in a dangerously inappropriate level of financial risk. While most attention has in the past been given to the availability and price of credit finance to the rural sector, this may not be a problem. Australian banks can and do raise funds for not only the Australian household sector but also from international bond markets for on lending within Australia. If a primary producer borrower has sufficient equity and reasonable prospects, there may be sufficient competition between lending institutions for him to obtain credit on reasonable terms.

However, finance spans a range between owner equity and credit. If primary producers can only finance themselves through pure owner equity and pure debt, there may be a financing gap.

Solving the financing problem of agribusiness

Where such financing gaps emerge in corporate enterprises, the usual solution is for the proprietors to issue equity to outside investors either through a private placement or through a public offering. For example, many small financial planning businesses as they have grown have been largely taken over by large listed financial-services groups. But "going public" and admitting co-owners may not be a feasible route for certain types of business. Small businesses owned or operated within family groups are not likely to become listed investment vehicles unless that group wishes to sell out or relinquish a large measure of management control. Yet farmers and graziers often want to keep ownership within a family (often a difficult enough exercise in itself) while arm's length investors do not wish to get involved the intricacies of running a small family business (often entwined with the family home).

At first blush, this seems an impossible divide. Primary producers wanting capital to grow and expand their business but not wanting to over-gear with credit on the one side; on the other, investors wanting equity-type returns but facing a sector which does not offer pure equity investment. But it may not be so impossible. The securitisation revolution has shown how bundles of formerly non-tradeable assets like mortgages over family homes may be traded.

It is therefore desirable to explore how the emergence of new institutions such as mortgage originators, community banks, and securitisation through collective investment schemes may help fill financing gaps emerging from the perceived withdrawal of subsidised credit from the rural sector.

The changing channels of Australian capital markets

Whereas banks were formerly the major intermediaries of finance, the emergence of widespread compulsory superannuation has resulted in a gradual shift of financing flows. However, superannuation funds are not generally equipped to lend directly to small farming enterprises and have to be conservative in terms of spreading risk. Even banks are less able to support the costs of an extensive network of bank branches in the face of competitive pressures for rationalisation.

Further, normal loans are not necessarily the best way for small farming enterprises to raise funds. Agriculture exhibits widely fluctuating returns - cycles of boom and bust, flood and drought. For such enterprises, excessive reliance on normal credit may be dangerous; what is required is a proper buffer of equity financing.

As financial flows increasingly move in the direction of large superannuation funds and governments and banks themselves seek to securitise their loans (eg the sale of the Defence Home Loan portfolio), many questions emerge.

These questions embrace a range of issues ranging from the provision of debt finance to equity and in between (the mezzanine floor) and include questions about the form of business vehicle bested suited to the needs of primary producers and their financiers.

Debt finance

Debt finance and lending attitudes

In the past, in big Australian rural industries debt finance may have been relied upon excessively. The result has been that in some cases restructuring has been necessary (often with public funds). But the idea that rural enterprises are unprofitable and therefore rural lending is unprofitable needs to be questioned. Aggregate statistics on rural profitability can be misleading due to the prevalence of hobby farms or non-commercial considerations. Perhaps the basic question is to ask whether primary producers are bankable, a question immediately answered by the observation that banks still find rural customers well worth lending to in a fully deregulated financial system. This leads to other questions.

1.1 How have bank lending patterns changed? Are banks finding it more difficult to carry primary producers through cyclical swings?

1.2 What has been the banks' recent experience and expertise in assessing viable customers: has there been an erosion of experience or corporate memory?

1.3 Can banks and pastoral finance houses improve credit risk assessment by contracting out to relevant professionals, such as risk assessors?

1.4 Has the emergence of new mortgage originators resulted in greater availability of debt finance to primary producers?

1.5 Is there a role for limited recourse financing for agricultural ventures? And, if so, is this an area for other venture capital financial institutions rather than banks?

Equity finance

Founders' or internal equity finance

Equity issues in Australian agriculture

At the other end of the financing spectrum is equity. Looking first at the initial owner's equity in a primary production venture, there are several issues which emerge. These first concern the business vehicle through which a primary production enterprise is carried on, for example, by a farmer and his family. Given the fluctuating nature of primary producer incomes and the large capital assets tied up in farming or pastoral businesses, the tax treatment of losses, capital gains and capital distributions flowing through to business owners has been of central importance to the net rate of return on primary production investments. In the past, death duties also had an influence.

Ideally, lenders and equity participants in an enterprise want a structure that -

- has a continuing existence apart from individual persons who may die, retire, get divorced or leave;

- has its debts and liabilities limited to its assets and recourse to members is limited to the extent of their investment;

- allows all losses to be offset against the profits of the enterprise in the year incurred or if there are no profits, to be offset against off-farm income of investors;

- allows capital to be moved into or out of the enterprise as required (subject to maintaining solvency) without tax penalty.

Choice of business structure

Business vehicles & structures in Australia

Unfortunately, the choice of business vehicle in this country has often had to be largely moulded by tax considerations because the normal commercial vehicle of choice, the incorporated limited liability company, is taxed more harshly in Australia than in other countries such as the USA or UK. Unlike the US Subchapter S corporation or limited partnerships or LLPs or LLCs which are taxed as a partnerships, Australia penalizes investment in risky or cyclical businesses through limited liability companies, limited partnerships or trusts. Capital distributions or distributions of surplus cash (eg from depreciation allowances) from companies or limited partnerships are taxed as dividend income while losses cannot be distributed to members and may indeed be cancelled altogether. Preference share dividends may be subject to double taxation.

Tax impediments

Such a tax regime inherently discriminates against risky or cyclical industries and explains why partnerships rather than companies are used as the vehicle of choice for farming or pastoral ventures, even if the underlying assets are held in companies or trusts for estate or marital asset planning reasons. It is not unusual for a primary producer business to be conducted through a family trust, a family company and a family partnership.

Obviously, anything which adversely affects the ability of a business to weather periods of adverse cashflow damages its creditworthiness and its attractiveness to an arm's length provider of debt or equity finance. While providers of debt finance, such as banks, can and do overcome problems of business structures by taking mortgages from trustees and personal guarantees from directors as well as direct liability of partnership debtors, the economic fact remains that a tax system which discriminates against cyclical businesses impedes their net returns and reduces their attractiveness to both lenders and investors. Further, while a "one to one" lender such as a bank may find it worthwhile to overcome business structure problems, they

would make it virtually impossible (even if desired) for the majority of farm enterprises to follow the historical route taken by many private companies of "going public".

Another issue which has arisen has been the increased regulation of superannuation. Prior to the 1980s, small businesses could invest their own "do it yourself" (DIY) superannuation funds back in their own businesses. Because of some notorious frauds on employee beneficiaries of such funds and an understandable desire to ensure that the failure of a small business does not destroy a family's whole financial future, "in house" asset rules were developed to prevent superannuation moneys being re-invested willy-nilly in a sponsoring employer's business. The result has been that much small business superannuation money flows into the hands of institutional superannuation fund managers who are not well placed to re-invest such flows back into the rural businesses from which they may originate.

Super impediments

In these circumstances, it is worth asking what can be done to remove impediments to superannuation savings flowing naturally back toward investment opportunities in the regions from which they may originate? The issue is not one of creating a subsidy or directing financial flows but one of recognizing a structural discrimination arising from superannuation policy changes and seeking to ensure that institutional investors are better able to satisfy the demand for capital from profitable smaller agribusinesses.

Among the questions which arise from the choice of business structure are -

Choice of business structure questions

2.1 *What are the problems for primary producers and potential lenders or investors with company structures?*

2.2 *How do tax issues such as those associated with deemed dividends, the quarantining or cancellation of losses, capital or capital gain distributions affect the return on farming and pastoral investment?*

2.3 *In relation to trusts, what is the potential impact of the proposed entity system on the return to primary production investment? What is the potential impact on continuity of farm enterprises through effects on loss utilisation, funds flows between proprietors and the entity, and on succession planning?*

2.4 *Should Australia adopt US-style Subchapter S or partnership treatment for small enterprises (as has been done in the UK and was discussed with the Close Corporation Bill which lapsed some years ago)? Would a tax system which allowed full integration and loss flow through provide a form of*

automatic stabilization of returns to rural investment which would allow the rural sector to compete for investment on more equal terms for lender and investor dollars with alternative investment in income-stable sectors such as real estate?

2.5 *Have the rules on self-managed superannuation funds not investing in "in house" assets meant that farmers' superannuation cannot flow back into building up the family farm except through some form of publicly-listed security?*

Third-party or external equity finance

Public issue of equity

The typical growth path for small business in the 1950s to 1970s was to "go public" when its need for equity capital exceeded the capacity of its founders to supply it. While it is hardly conceivable that single-family farm enterprises would ever be publicly floated, there is a range of arms' length outside equity investment in rural projects. Often stigmatised as purely motivated by tax considerations (now a matter of fierce debate), it is clear that there is a market for unlisted and listed equity investment in agricultural, forestry or pastoral enterprises. Indeed, it was Victorian forestry schemes in the 1950s which led to the requirement being adopted in the Uniform Companies Act of 1961 that all schemes offered to the public had to have an independent trustee to represent investors' interests.

Managed Investments Act problems

Recently, the new Managed Investments Act has removed the requirement for an independent licensed trustee company and indeed forbidden their use. Managed investment schemes are now conducted by single responsible entities. This change may affect the ability of small rural investment schemes to attract equity capital from the public - an investor may be willing to invest in a horticultural or viticultural unit trust managed by a primary producer if he or she knows the administration is watched over on a day to day basis by an independent licensed trustee, but may be hesitant to commit equity capital to an unknown single responsible entity promoting its own managed investment scheme (assuming that a small rural producer would succeed in obtaining a licence from ASIC to promote such a venture in the first place).

In relation to such third party or external equity investments in rural production, the following questions arise -

2.6 *Do prospectus requirements hinder the ability of the rural sector to obtain equity finance?*

Equity investment questions

2.7 *Has the Managed Investments Act, by removing the option of trustee-supervised managed investment schemes, hindered the*

ability of rural investment schemes to make equity offerings available to the public?

2.8 *Has the ATO product ruling system been successful in promoting public confidence as to the tax consequences of rural equity investment?*

2.9 *Is there scope for a second board or NASDAQ-type exchange for smaller companies or interests in smaller investment schemes, including rural enterprises? Does previous experience with such second boards caution against such an experiment?*

Securitisation of assets and cashflow

Historical background to securitisation

So far, we have presented debt and equity as two opposed poles. Either finance is supplied as an interest bearing loan with full recourse to the borrower or by way of equity in the business itself (either as partner, unit trust beneficiary or shareholder) ranking on the same footing as the original owners.

But the financial sector has been more sophisticated than that for generations. In the Middle Ages limited partnerships evolved as a means to circumvent the ban on usury and a limited partner was thought of as a profit sharing creditor. Limited partnerships were adopted in France and Ireland in the 17th and 18th centuries, and in the early nineteenth century in New York They were even used in New South Wales before general incorporation was permitted. In the UK *Bovill's Act* (which permitted profit-sharing loans) was followed by a general Limited Partnership Act in 1908 (adopted subsequently in Tasmania, Western Australia and Queensland).

Meanwhile, company law (originating largely from partnership law) was developing. Different classes of share such as fixed or participating redeemable preference shares were developed, convertible notes were used and profit-sharing debentures developed. Many of these old forms of company security are being given new names and transformed into instruments such as ReCAPS or reset convertible preference shares.

Hybrid and mezzanine financial instruments and risk sharing

In short, finance does not have to be equity or debt. At the end of the day, finance is relatively simple. An investor or lender A is considering laying out money now for a future return by giving it to person B. Whether he does so depends on the likely yield and its security of being realised. There is no inherent need for that cash flow by way of return to come back as a fixed amount of loan interest or as a company dividend. Hybrid or mezzanine financial instruments allow the parties to cover the full spectrum of risk

sharing and are typically needed for start-up or variable return investments.

A debt financier, such as a bank (which has to remember always that it must repay its depositors on demand) will want strong security and a defined return. A long-term equity investor has different considerations. Unlike a mere lender, he or she must consider the principal-agent problem. Is the return to depend on management decisions which may conflict with my interests? Am I to be a minority equity holder? What is the upside? If there are losses, do I have any liability and can they be used? Do I want to invest in a business so that my return is computed as a net amount after all business decisions (which I may have no influence over) or as a percentage of gross proceeds?

Thus, sharecropping and mineral joint ventures are examples of equity investments where an investor may look to a share of output without necessarily being liable for all costs.

Conversely, a small business which does not wish to take in full equity participation from outside investors may be quite amenable to raising funds by way of other forms of profit or gross proceeds participation. The Partnership Act, for example, recognises that no liability as a partner need attach to a person who advances funds to a business for a share of the gross proceeds of that business or as a loan with the interest return contingent upon profits.

Futures contracts in agricultur

In a world of global capital all primary producers must think as agribusinesses, whatever their ownership structure. This is not necessarily as strange as it may seem. It was the great American Mid-West which gave rise to the Chicago Mercantile Exchange and perfected the standardised futures contract for forward delivery of agricultural commodities. That simple concept has spawned the innovation in the financial sector of interest rate and stock price index futures. The financial sector and the rural sector owe more to each other than is commonly realised. Farmers, faced with price risks, were early users of futures as financial instruments to lay off risk.

Securitization and hybrid financing

But futures go only so far. A futures contract allows a rural producer to lock in a price for his output but it does not cover the risk that the output may not materialise (eg due to fire or flood). A form of equity finance is necessary if primary production businesses wish to raise capital for business expansion without being liable to a fixed commitment for interest payments when a crop fails. Rather than just selling forward a part of the crop for a season, can rural producers raise funds by selling part of their gross or net cashflows for a period? If gas pipelines can be financed by banks on the security of "take or pay" contracts, can agribusiness improve its creditworthiness by selling forward claims over its output?

At the outset, it will be seen immediately that securitisation of cashflows does not require that those cashflows be dividends on corporate equity or partners' profit shares. Just as securitisation of home mortgages does not require investors to negotiate one-on-one with homebuyers, is it possible to think of securitising cashflows from primary production in a way which does not require investor participation in rural business management and which avoids the potential moral hazards of the principal-agent problem?

Can securitisation in Australian agribusiness improve?

It is easy to see why securitised rights to a share of primary production output could be attractive to both producers and investors.

Investors such as superannuation and managed funds as well as individuals could be expected to welcome investor access to funds which represented a share of the Australian crop of wheat, cotton, rice, wool, beef, sugar etc. They would be able to further diversify their portfolios.

Primary producers might see such securitisation as a further development from futures contracts. They would be able to lay off not merely price risk but output risk.

Investors could also include primary producers themselves. A farmer producing, say, only wheat could hedge his risk by selling forward part of his crop in securitised form and swapping the proceeds into a right to a securitised share of other crops.

Securitisation requires product standardisation, elimination of extraneous and unwanted risk, bundling up the securities, custodianship of securities and the income therefrom and marketing of rights to the securities to the general investing public whether as listed or unlisted securities. This raises many issues.

For the purposes of the following discussion, we must identify the likely parties who might turn out to be involved in securitisation of primary production. Needless to say, it is a highly speculative business to prognosticate on a market which does not yet exist and the purpose of this Issues Paper is not to prescribe but to raise questions and suggest lines of inquiry for discussion, criticism and development by readers and Conference participants.

- First, there are the primary producers themselves (referred to below as "primary producers", "agribusinesses" or "farmers"). Their interest is to ensure that they have a liability structure which is robust enough for the cyclical nature of their businesses. They, like homebuyers with securitised mortgages, are the ultimate parties liable on any securitised agricultural product (the primary security).

- Second, there are the immediate investors in purchasing and holding any primary security (referred to below as "commodity funds"). These might be either listed investment companies or managed funds or unit trusts, for example. Their interest is to purchase, hold or trade a portfolio of primary securities to profit from a stream of commodity linked receipts.

A model of securitisation

- Third, there are the ancillary institutions involved in creating and enforcing any primary security contract. There would have to be a party to handle the sale of the crop and a registry to record primary security claims over crop cheques (ahead of unsecured creditors) and a trustee or custodian to ensure that claims were discharged and holders of primary securities paid. Banks as senior lenders may become involved, whether through requirements to give consent to the creation of claims over crop cheques or second mortgages by way of additional security for the primary security or as custodians themselves. Banks, of course, have another interest, in ensuring that their rural customers are not over-reliant on debt finance and might find that assisting their customers replace debt with quasi-equity finance contributes both to their customers' financial viability and the quality of the banks' own direct rural loan portfolio.

- Fourth, there are the final investors in any commodity funds which hold the primary securities. These investors might be expected to want to hold shares or units in such listed investment companies or managed funds as a means of either profiting from changes in the price and quantity of rural output or as a means of hedging for their own processing requirements - a bread manufacturer, for example, who may not always be able to pass on cost increases to customers, may ease a profit squeeze on processing operations by a gain on its income from the revenue of a commodity fund.

This leads to the following questions:

3.1 What are the moral hazards involved in crop securitisation?

Moral hazard questions

Using the phrase "crop securitisation" in an expanded sense to cover a claim over any share of primary producer output, there are moral hazard issues to be addressed. Presumably the farmer (more generally, any primary production or agribusiness) would not face a moral hazard problem because he or it gets the quasi-equity funds injection up front. But for the financier buying the part-equity in the crop there are moral hazard problems. How does he make sure the farmer does not slacken on his production efforts? How does he make sure the farmer does not sell the crop via another party and fail

to account for the proceeds? Who handles the proceeds of sale? How can a claim against the crop be registered so as to take priority over payment to the farmer or his creditors in insolvency? These sorts of intensely practical issues have to be sorted out before any financier (for example, a commodity fund) would be interested in parting with its money, let alone any potential investors in such a fund.

3.2What might be securitised - net or gross cashflows?

Cashflow & agribusiness management questions

In theory, any right might be sold. In practice, to buy a right to the net cashflow of a business is to expose oneself to any wasteful or foolish cost decisions of management. In the past, one of the problems claimed to exist in agribusiness was the inability of centralised corporate management to exercise "on the ground" supervision - a salaried manager may have no great incentive to maximise profit or control costs. In order to preserve incentives for cost control one can envisage that investors might be more interested only in a specified portion of the gross cashflow from a given farmers' crop for a given period. This minimises the need for the investor to know or care about the actual management of anyone of thousands of farms he may indirectly be interested in - if the cropsharing contract provides for the farmer to receive a fixed proportion of the crop and bear all the costs this tends to give the farmer powerful incentives to minimise costs and maximise output. The principal-agent problem might to that extent be minimised.

3.3 What legal form could a claim to a share of the crop take - debt or equity or pure contract?

How should security claims be structured?

In theory, a claim to a share of the output of a farm is a matter of pure contract. But few investors would invest in a commodities fund which held such contracts. A simple personal contract might be frustrated or defeated, for example, by the death or insolvency of a party. There has to be some security for due performance of the contract. Just as loans can have equity kickers so it seems possible to imagine the purchase of a crop share being done by way of subordinated loan, backed by a second mortgage over real property, which is treated as discharged pro tanto for each year the crop share is delivered. If an obligation to redeem a preference share can be discharged by delivery of ordinary shares there seems no reason why a loan of, say, $200,000 could not be amortised over 10 years by delivery of a share of the crop each year being treated as discharging $20,000 of the debt each year (recovery of the debt being limited to recourse against the crop cheque each year with no accounting for any surplus). At the end of the day, there is a great freedom in common law to use different legal concepts to generate an outcome which amounts to cash passing from A to B now in return for a share of

returns for a period in the future. In effect, the issuing of a primary crop security by a farmer would be like replacing debt with quasi-equity, but with a contingent liability to redeem the quasi-equity should its claims not be met.

3.4 What covenants might be necessary in a primary security?

Fragile legal structures in agribusines

There are a range of issues an acceptable primary security would need to cover. For example, it would be unacceptable to a commodity fund holding a primary security for a third of a farmer's wheat cheque for 10 years if that farmer were able to defeat that contractual obligation by being free to switch to growing barley for the next 10 years. There would need to be covenants for either no crop switching or for an "all output" lien or for a minimum delivery amount to protect against such a moral hazard.

Other issues are raised by the fragility of the legal structure of many rural enterprises. As banks know, small business often terminates through death, divorce, disability or family disputes. Just as holders of mortgage securities seek to protect themselves against unemployment of a mortgage borrower, so any commodity fund holding a primary security (which amounts to a form of quasi-equity) might need to ensure that there are covenants not only for crop insurance but also for insurance of the keyman in the enterprise and a second mortgage on the farm property to cover non-performance over the remaining life of any crop-sharing contract. Another possibility would be for a bank to provide a guarantee to cover against such possibilities of contract non-performance (which it may be happy to do where the proceeds from issuing the primary security were used to reduce reliance on bank debt).

3.5What bodies might hold and deal with claims on crop cheques?

In any system for establishing claims over, or interests in, real or personal property, there has to be some system of registration of interests. This has always been recognised in legal provisions for registration of deeds, company charges or stock mortgages. These are necessary to ensure security holders do not lose their rights and become unsecured creditors in an insolvency of the business which has issued the security. Third parties dealing with a primary producer need to know what his net crop cheque really is, just as potential lenders or shareholders need to know with some certainty what a company's financial liabilities already are. But because holders of primary securities would not necessarily be dealing with bodies filing public audited accounts, there has to be some other form of public recording.

Australia's statutory marketing boards – could they play a role?

Just as Robert Torrens adapted the system of registering interests in British ships to registering ownership and security interest in land and just as the CHESS system of the ASX has overtaken multiple company paper share registries, so one can envisage a natural role for central marketing boards in registering claims over crop or rural output cheques. In a sense, as with stock exchanges, there is a potential natural monopoly in the operation of any registry system.

In theory, any mutually trusted warehouse or sales agent could act as a central registry for collection and dividing up of crop cheques between agribusinesses and immediate investors. In the current institutional framework, central marketing boards may have the advantage for both primary producers and potential holders of primary securities of being a trusted third party, often with statutory powers to ensure no diversion of a crop and to supervise its export or marketing. Where a central marketing board has irrevocable contractual or statutory powers to sell and collect the proceeds of sale as a farmer's agent, it makes that body a natural potential registry for primary securities. Also, like the company reports filed with a stock exchange, the records held by a central marketing board of a producer's crop deliveries over the years would provide valuable, third party certified, information for commodity funds to work out a fair market price to pay any farmer seeking to issue a primary security.

An interesting issue (but beyond the scope of this issues paper) is whether, were marketing boards to emerge as registries for claims on crop cheques, they would need some public interest exemption from competition policy rules to perform a quasi-public function as public registries.

3.6 What might be the role of custodians or trustees?

Trustee role ?

Any commodity fund holding primary crop securities and wishing to attract public moneys from secondary investors to fund its operations would need to satisfy such investors that its affairs were properly managed. In addition to any requirement under the Managed Investments Act, it is likely that secondary investors would want an independent third party such as a trustee company or bank to be registered as the title holder with the registry of any primary securities. Secondary investors are willing to make their own judgments on price or output risk, but like all persons of business, they do not wish to run risks of mismanagement or fraud. The normal commercial principle is therefore to ensure that investment decisions made by any fund are separated from control of the record keeping and that assets are kept under third party control so that they cannot be improperly dealt with.

3.7What might be the tax treatment of any crop-sharing security?

Tax neutral treatment essential for mezzanine or hybrid security investors

Naturally, there are various possible tax treatments depending on the form a crop-sharing security might take. If done as a pure contract it might be treated as a pre-sale, if done by way of a return to a redeemable share in a business structure it might be expected to be treated like any other form of equity and if done by way of debt it might be treated as capital except to the extent of any profit or loss to the investor. It is important that a tax-neutral treatment be assured to investors holding primary or secondary securities based on mezzanine or hybrid financial instruments. If a tax system tries to squeeze hybrid or mezzanine instruments into conventional debt/equity tax boxes, it may stymie investment. Structural tax distortions such as double taxation of income or denial of flow through of losses should not occur: taxation considerations should not be allowed to prevent economically efficient risk sharing. As venture capital investors in the USA and UK well understand, without a tax-neutral treatment (eg as for US and UK limited partnerships) it is impossible to persuade any institutional investor such as a superannuation fund to take a mezzanine or hybrid equity interest in any venture, no matter how socially or economically worthwhile in the long term. The ensuring of a tax neutral treatment for mezzanine investors raises both policy and technical legal issues (like insolvency issues) which would need careful exploration before any form of crop security could be marketed.

3.8 What prospectus requirements might be required?

Other technical issues

To the extent that commodity funds might be financing individual farm or agribusinesses, no prospectus requirements would appear necessary (though Credit Acts may apply). To the extent that interests (whether shares or units or limited partners' shares) in such commodity funds were in turn offered to the investing public they would appear to fall under the scope of the Managed Investments Act and require responsible entities as managers and custodians (eg trustee companies) for scheme assets.

Concluding thoughts

This conference raises several issues in rural and agribusiness finance.

- First, is there a problem in better integrating Australia's financial services with the growth of agribusiness? And if there is, is it a question of inadequate debt or equity finance?

- Second, can Australian primary producing industries be financed through the issue of equity or hybrid debt/equity or debt securities? Can such financing be made compatible with

smaller scale farming enterprises undertaken through partnerships or trusts?

- Third, could standardised quasi-equity crop securities be developed for investment? Are there institutions which could operate central security registries for bulk portfolios of such primary crop securities?

- Fourth, would secondary investors, whether domestic or overseas, welcome the chance to buy a stake in commodity funds which represented claims to Australia's rural output?

Can Australian agriculture engage itself in the mainstream of financial internationalisation?

In a way, these issues are not new. Agriculture has always had equity or quasi-equity participation from absentee investors, whether through simple share cropping contracts, forward contracts or profit sharing loans to partnerships. But agriculture has been dominated by small scale agribusinesses which have been unable to obtain access directly or indirectly to capital from the public equity markets. The issue is really whether old forms of quasi-equity participation in agriculture can be modernised so that global and institutional capital flows can be tapped for the better development of Australian agribusiness.

The creation of large, liquid, markets in tradable securitized rights to agricultural cashflows would be a natural progression of financial development through the ages. It took centuries for agricultural trade to develop from the corn factors of Rome to the futures exchanges of Chicago and London but the pace of financial innovation suggests that the financial and agricultural sectors will be quick to help each other maximize opportunities for more efficient capital management.

So far, Australian agriculture has tended to remain apart from the great securitisation revolution of the 1980s and 1990s in financial markets. But can agriculture remain aloof? Is there a future for agriculture without some means of tapping into domestic and international equity market capital flows? If agriculture cannot tap into the full range of capital sources, will its capital costs and structure remain higher and more risk-prone than they should - to the detriment of Australian primary producers' competitive advantage?

These are questions this Issues Paper suggests are there for the asking - the answering we hope will start to come from Conference participants. To the extent that more efficient financing instruments can be developed for contemporary Australian agribusiness the nation's economic growth and its international competitiveness will be further enhanced.

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