Productivity Commission Inquiry into Drought Policy

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Background

Government assistance for drought events is guided by the current National Drought Policy (NDP). Under the NDP, drought assistance or support is intended to be a short term measure to help farmers prepare for, manage and recover from drought. The objectives of the NDP are to:

- encourage primary producers and other sections of rural Australia to adopt self-reliant approaches for managing a changing climate;
- maintain and protect Australia's agricultural and environmental resource base during periods of extreme climate stress; and
- ensure early recovery of agricultural and rural industries, consistent with long-term sustainable levels.

Although self-reliance is a key objective, the NDP also recognises that there are rare and severe events that are beyond the ability of even the most prudent farmer to manage. The Commonwealth Government provides support to farmers and rural communities under the Exceptional Circumstances (EC) arrangements and other drought programs. The state and territory governments also participate in the NDP and provide support measures of their own.

To be classified as an EC event, the event must be rare, that is, it must not have occurred more than once on average in every 20 to 25 years. Australia is experiencing a drought that has been unprecedented in its geographic extent, length and severity. Some areas have been drought declared for 13 of the last 16 years, leading to some recipients receiving EC assistance since 2002.

Climate change will bring with it significant challenges for Australian agriculture. Climate change is expected to increase the frequency, severity and length of drought periods in future.

Australian primary industries ministers have agreed that current approaches to drought and EC are no longer the most appropriate in the context of a changing climate. They agreed that drought policy must be improved to create an environment of self-reliance and preparedness, and encourage the adoption of appropriate climate change management practices.

To improve drought policy, ministers agreed to consider:

- relevant social dimensions and policy responses to drought and Exceptional Circumstances;
- the provision of accessible social welfare support, including eligibility criteria;
- the effectiveness of business support payments;
- the effectiveness of financial risk management strategies, including Farm Management Deposits;
- the effectiveness of preparedness policies; and
- cost-benefit analysis of state and federal drought assistance.

1. The response of banks to drought conditions

Australian banks have a long history of working with farmers through seasonal cycles, and put in place arrangements to address special financial needs in times of drought. Banks recognise that managing the financial impact of drought is a normal part of the business of farming in Australia.

Banks work with Governments that provide assistance to farmers and rural communities in times of drought in the form of interest rate subsidies, fodder subsidies, fodder transport subsidies, livestock transport subsides, crop planting grants, general grants, unemployment benefits and Austudy assistance.

Banks manage the impact of drought on customers on a case-by-case basis reflecting varying impacts and options available to individual customers. The financial position of individual customers varies and this determines the options that are available.

Since 2001-02 rural indebtedness to banks has increased from about \$27billion to \$47billion in 2006-07. An increase in the provision of credit in the order of \$20billion dollars. Over this period the number of agribusiness customers categorised by banks as being 'at risk' has remained at historically low levels. In 2006-07, Government drought support for rural business in the form of "interest rate subsidies" equated to less than 1.5% of debt outstanding in the rural sector (agriculture, forestry and fishing).

It needs to be noted that to receive an "interest rate subsidy" in most States you need your financier to commit to continue to support you for 12 months. However the financier does not have a claim over this money and it can be used by the customer for what ever purpose they choose.

Farmers and other rural businesses experiencing difficulties because of drought need to understand their financial position so that they can work together with the bank to identify the options that best suit their business.

During drought:

- farmers and rural businesses will want to identify and manage all costs that can be deferred in the short-term;
- in some cases, individual banks may, as a short-term measure, typically lend farmers carry-on finance to enable shortfalls in cash flow to be met;
- farmers that already have significant debt need to be prepared to draw on financial reserves such as Farm Management Deposits, investments in managed funds and other forms of off-farm investments; and
- in some cases to help reduce cash out-goings, individual banks may put in place the short-term measure of restructuring existing loans so as to reduce annual debt repayments - this may involve extending the term of a loan or allowing interest-only payments for a period of time.

During the drought individual banks have offered:

- to provide carry-on finance to meet short term needs;
- to restructure existing loans, to reduce annual payments or defer payments without cost;
- to waive costs on accessing deposits including Farm Management Deposits;
- no change in risk margins where interest rate subsidies are received;
- direct communication with customers about the banks view about drought issues;
- support of specialised advice to industry groups such as dairy farmers;
- similar support for drought affected small businesses that provide services to Agribusiness;
- targeted courses to assist farmers plan to recover from drought and;
- recognition of the potential impacts of drought on the welfare of farmers and their families, livestock and the environment.

Banks have also increased their competitiveness for rural business/agribusiness during the past decade by increasing the range of products available.

There is no compelling case that there is a failure of rural credit financial markets that warrants Government intervention in the provision of financial services to agribusiness.

2. Ability of bank customers to manage the recent drought

The ability of customers of banks to manage the recent drought is evidenced by there only being a historically low the number of agribusiness customers categorised by banks as being 'at risk' over the extended period of drought.

The extended drought, as severe as it has been, occurred after several reasonable production seasons, reasonable commodity prices and when interest rates were at historically low levels. Commodity prices have continued to be favourable, as is their future outlook. This in turn has and continues to support rural land prices which has helped farmers maintain equity and as a result access further finance. The timing of the start of this prolonged period of drought has also meant that many of the farmers that had borrowed to improve their economies of scale had the opportunity, due to favourable climatic conditions and prices, to recover their financial positions.

The above factors have combined to create an environment where the majority of farmers affected by drought have been able to manage it. There are exceptions including irrigation areas where access to water is either not available or the cost is too high. The availability of government assistance has also encouraged financiers to continue to support farmers have needed to increase borrowings to finance working capital as a result of the extended period of drought.

ABA agrees with ABARE's research (Farm Financial Performance, Australian Commodities March Quarter 08) which indicates that in 2006-07, the proportion of broad acre and dairy producers with low equity increased to around 15 per cent. Of these producers, about a third, or just 5 per cent of all broad acre and dairy producers, had low equity and negative cash flows in 2006-07. During 2007-08, producers with low equity and negative incomes in 2006-07 achieved a significant improvement in farm cash flows. While the improved cash flows were projected to enable these producers to reduce debt levels, this has been achieved via a significant reduction in animal numbers and reduced livestock production potential in 2008-09. Without access to debt facilities, these producers may struggle to improve their farms' viability in coming years. For the majority of broad acre and dairy producers, who either have high equity or strong cash flows, 2007-08 is projected to be a year of recovery. Strong cash flows leading into 2007-08, combined with the recovery in grains sales, is expected to enable most producers to rebuild livestock numbers and reduce debt levels. If seasonal conditions permit, the majority of Australia's broad acre and dairy producers are in a strong position to expand production and enhance profitability in 2008-09.

ABARE also notes that new investment in plant, machinery, vehicles and improvements has also been sustained at historically high levels during the 2000s. ABA is of the view that this indicates that the majority of farmers are continuing to reinvest in their businesses to maintain their self reliance by ensuring that their productivity is sustainable and are not relying on Government assistance to remain viable.

3. The Government's Broad Policy Setting – Self-reliance and rationales for government drought support

Commonwealth and State Government drought and rural adjustment policies over the past decade have moved increasingly towards encouraging self-reliance.

For a significant proportion of farmers self-reliance is a strategic objective that has consistently been a focus of their business/commercial activities and therefore they are not reliant on direct Government support for their activities and typically have implemented pre-emptive actions to deal appropriately with cyclical conditions such as drought.

Under this policy setting drought is recognised as a normal part of seasonal variation that Australian farmers can plan and manage for, but it is also recognised that exceptional circumstances (EC) can go beyond what can normally be planned for, and government assistance is made available at these times.

Government support for farmers experiencing EC conditions is targeted at maintaining viable businesses and ensuring that farmers are able to meet the day-to-day needs of their families.

EC events by definition need to be exceptional otherwise farmers and other stakeholders may have an expectation that government assistance will be made available during normal unfavourable climatic events. There needs to be a clear understanding of what an exceptional circumstance is and it should relate to the ability of individual businesses and their communities to recover from the circumstance.

It is important that this is clearly understood by all stakeholders and especially when considering further investment in the sector.

Very few farmers leave the industry during financial downturns, such as severe drought because of the adverse impact on their asset values. Government assistance plays an important role in ensuring that the exit of farmers from the industry is orderly by relieving pressure to sell assets in the middle of severe drought. The number of farmers leaving agriculture is greatest during relatively good times when land values are high and neighbouring farmers have the financial capacity to expand. Government assistance therefore helps preserve the equity of farmers needing to leave the industry, which maximises the options available for them after farming.

ABA supports this general policy setting. However it is recognised that while many farmers have adapted to the new self-reliant policy environment by changing management strategies and building up reserves, the capacity of some farmers to adjust to the change has been limited by a range of possible factors including the scale of their operations, and/or their ability to manage change.

Due to issues such as inefficient economies of scale, a significant proportion of farmers are unable to put into practice appropriate fully effective self-reliance risk management strategies.

Ongoing impediments to adjusting economies of scale in agribusinesses mean that a purely self-reliant drought policy setting cannot fully succeed on its own.

At any point in time there will be farmers whose farms are too small, or those who have recently increased the scale of their operations and who subsequently are not well placed to manage a significant financial downturn, like that caused by a severe drought.

Off-farm income plays a significant role in underwriting the viability of relatively small farms, as a means for small farms to build cash reserves, and as a means of creating a capital base to invest in better economies of scale. A level of off-farm income that offsets the normal variability of income in a farm business should be recognised as a legitimate self-reliance measure.

Options such as joint ventures and leasing avoid the need for land purchase and therefore can help manage the financial risk of expansion. Government should promote these options and remove impediments that discourage their implementation.

As a result of this, a case can be made for ongoing government intervention to facilitate the ongoing transition to self-reliance and to address short-term welfare issues that arise when external events have significant financial impact on the rural sector, such as a severe drought.

Another justification for Government assistance at times of exceptional drought is that farmers are increasingly expected to accept financial responsibility for natural resource stewardship. Government regulation in this area can affect the ability of a property to generate cash flow and also its capital value. Farmers are best able to address environmental objectives if they have financial capacity to do so. Drought, directly and indirectly, has implications for the financial ability of farmers to manage natural resource issues.

ABA identifies 3 separate target groups for which government assistance in times of severe drought is justified. These groups need different forms of government assistance.

- farmers, including young farmers who have recently borrowed to grow their business with the aim of being self reliant, who due to their debt levels are vulnerable to the risk of severe drought
  - interest rate subsidies may be the appropriate form of assistance but could also include grants for specific projects relating to drought management
  - it should be noted that some State Governments have programs in place that offer interest rate assistance to young farmers
- mature business of appropriate scale and equity
  - FMD's to encourage and assist them build and easily manage liquidity reserves in preparation for severe drought
- Small inefficient farm businesses that are unlikely to be viable going forward
  - Welfare and exit grants

3.1 Ability of farmers to be self-reliant

The ability of farmers to manage drought is dictated by the strength of their balance sheet. While there are exceptions, generally farm businesses with appropriate economies of scale and gearing levels have been able to manage drought conditions.

Evidence of this includes the strength of the rural property market during the drought, which has predominately been supported by farmers buying additional property. This indicates a scope to borrow funds during a financial downturn.

Appropriate gearing levels are important because they provide scope to borrow funds to address cash flow shortfalls. Economies of scale are important because they dictate the efficiency at which cash flow can be generated to pay off short-term borrowing and build up cash reserves.

Drought is one of many potential external impacts on farm businesses that can create a financial downturn. If drought occurs at the same time as a down turn in commodity prices and/or a rise in interest rates the financial impact of drought is magnified.

The most immediate effect of drought on a farm business is typically its negative impact on production or outputs. Flow-on effects often magnify the effect of other risks, such as:

- Price risk
  1. volatility of prices gained for product grown and product purchased (e.g. feed)

- Financial risk

  2. dependent on amount of debt the farming enterprise is carrying and the sensitivity of performance to changes in financing costs

- Production risk

  3. the method utilised to produce the product, which drives the costs of the business and affects its ability to withstand major events

Risk management is critical to the success of a farm business during drought. Further, drought management is a critical part of the overall risk management practices necessary for farm businesses.

Farm businesses that are able to manage drought generally have the following characteristics.

- Business plans include a response to drought conditions.
- Capital structure (equity level) readily enables access to commercial finance to offset cash flow short falls if required.
- Off-farm assets that can be readily converted to cash.
- Off-farm income.

Farm businesses that are at risk of the impact of a severe drought generally have the following characteristics.

- Business that don't plan for drought.
- Businesses where the capital structure does not readily enable access to commercial finance:

  4. businesses that have accumulated debt rather than managed their capital structure;
  5. businesses with low debt levels but limited scope to borrow because of poor economies of scale and little or no external sources of income; and
  6. businesses with appropriate economies of scale but have recently financed significant increases in their production capacity

- Businesses that do not have the capacity to borrow and do not have off-farm investments that can be readily converted to cash.

3.2 Impediments to the ability of farmers to be self-reliant and role of off-farm income

The introduction of new technologies, the globalisation of commodity markets, the removal of protective tariffs, the deregulation of domestic marketing arrangements have all contributed to reducing the profitability of small farms. Due to efficiencies associated with economies of scale, for most commodities increasing farm size is linked to higher rates of return, making larger farms more economically viable than small farms.

For some farming families, family members have needed to obtain off-farm employment to supplement and stabilise the family income. Over the last two decades Australian farming families have become increasingly dependent on off-farm income to maintain their standard of living. During times of financial hardship, off-farm income can moderate the effect of a reduction or significant variability in farm income.

Drought can result in the accumulation of debt that subsequently impedes the potential of small farms to increase the scale of their operations.

Without access to off-farm income, increasing economies of scale by borrowing to purchase additional property can significantly increase financial risk, which reduces scope for self-reliance in managing financial down turns. The opportunity to purchase the neighbouring property can be a once in a life time strategic opportunity to improve scale. The timing in relation to seasonal conditions and commodity prices of this opportunity is critical given its typical impact on the businesses equity.

Farms with poor economies of scale also find it difficult to generate reasonable returns to be self-reliant.

The inability of farmers with poor economies of scale to manage down-turns is further exacerbated by pressure to maintain the natural resource base and vice versa.

Off-farm income plays a significant role in underwriting the viability of relatively small farms, as a means for small farms to build cash reserves, and as a means of creating a capital base to invest in better economies of scale. A level of off-farm income that offsets the normal variability of income in a farm business should be recognised as a legitimate self-reliance measure.

Problems with economies of scale can also be addressed via joint venture arrangements and leasing. These options avoid the need for land purchase and therefore can help manage the financial risk of expansion. Government should promote these options and remove impediments that discourage their implementation by farmers.

Recommendation 1: ABA recommends that the Government's current broad policy setting of self-reliance be maintained.

Recommendation 2: ABA recommends the continuation of the provision of government assistance at times of extraordinary circumstances that go beyond what can normally be planned for.

Recommendation 3: ABA recommends that Government support for farmers experiencing EC conditions remains targeted at maintaining viable businesses and ensuring that farmers are able to meet the day-to-day needs of their families.

Recommendation 4: ABA recommends that impediments to the adjustment of small farms to self-reliance should be recognised by Government and proactively addressed.

4. Policy design

ABA supports the Government's current general policy settings and believes that the policy of providing assistance in Exceptional Circumstances can be adapted to take account of expected climate change.

In response to climate change a relatively minor change to government drought policy would be for the Federal Government to change the definition of an event that is now regarded as an EC drought and for State Governments to vary their view of what is a viable farmer to reflect this. Alternatively eligibility assistance could be targeted to support farm businesses that are proactively investing in their business to improve their self reliance. Welfare support should continue on a needs basis. To help manage the transition governments could assist farmers put in place measures that improved their ability to manage an expected increase in frequency and severity of drought through extension and targeted financial assistance. For example stock containment areas, varying stocking rates to reflect forecasted seasons, improved water storages, improved on farm fodder storage, business management training, and extending eligibility criteria for FMDs.

4.1 Exceptional circumstances process

Planning ahead to mitigate the impact of drought on individuals, industries, communities and the Australian economy is essential. It is appropriate that government policy work to move as many farm businesses as possible towards the position where they are less reliant or not reliant at all, on external assistance during drought events.

Government support during exceptional drought conditions will always be important, but the policy emphasis should remain on providing incentives for farmers to prepare their businesses for inevitable drought.

For a self-reliance policy setting to work, farmers, their bankers and other advisers, need to be able to determine when government assistance will be made available in terms of the impact on the business's cash flow and its financial position.

A one-in-25 + year drought (that might be regarded as an exceptional circumstance) that occurs when commodity prices are strong and interest rates are low may be more manageable than a one-in-seven year drought that coincides with a downturn in commodity prices and increase in interest rates.

The EC policy focus should be on providing assistance to businesses that have been impacted by an event or a number of events, that puts the business at risk and the risk of the event or combined events could not be managed under normal business circumstances.

Defining areas as EC declared inevitably leads to inequities, as there will be businesses outside the boundaries that are more adversely impacted than some within. The recent drought has also shown that intensive industries can be adversely affected by an EC event but not be in an EC declared area.

There needs to be a national approach with significant inconsistencies between States not allowed by the Federal Government.

The form of assistance should be flexible to suit the needs of the individual business and should not be purely debt focused. An assessment of the risk management practices of the businesses should also be taken into account in considering eligibility, as well appropriate environmental management and animal welfare plans for times of drought.

Off-farm income plays a significant role in underwriting the viability of relatively small farms, as a means for small farms to build cash reserves, and as a means of creating a capital base to invest in better economies of scale. A level of off-farm income that offsets the normal variability of income in a farm business should be recognised as a legitimate self-reliance measure.

It is important that the State, Territory and Commonwealth governments' initiatives are consistent and implemented in a timely manner to ensure all benefits are passed onto farmers as efficiently as possible.

The trigger for declaring an exceptional circumstance event should be clear and not lend itself to dispute or controversy.

Removing the trigger approach to EC could make the availability of assistance to farmers more targeted, predictable, and timely. Eligibility criteria could be structured to encourage the implementation of risk management practices and appropriate environmental and animal welfare practices.

4.2 Business support measures

EC assistance should not impede adjustment of inefficient farms that are not actively seeking improvements in productivity. Agribusinesses that are mature and are not seeking further growth could be expected to have high levels of equity and liquid assets, including FMDs. Given their asset values they are likely to be able to withstand periods of severe drought.

Businesses in a growth phase are likely to have taken on debt to finance investment that will lead to improved productivity. As a result these businesses are at risk of a severe drought. Younger farmers are also likely to be highly represented in this group and may be regarded as a worthy target for government assistance. It is also unlikely that these farmers are holding significant liquidity reserves, including FMDs, as they are likely to be giving priority to paying down debt. If Government assistance is targeted towards these businesses it is unlikely to impede adjustment and will support local communities who are providing them with increasing amounts of inputs as they grow their businesses.

It is noted that some State Governments proactively assist young farmers investing in agriculture.

Recommendation 5: ABA recommends that the issues that make the process of determining eligibility for EC assistance, slow, complex, and unpredictable be addressed.

Recommendation 6: ABA recommends that a level of off-farm income that offsets the normal variability of income in a farm business should be

recognised by as a legitimate self-reliance measure in assessing eligibility for EC assistance.

4.3 Role of Farm Management Deposit Scheme (FMD)

ABA supports the continuation of the Farm Management Deposit scheme.

The FMD Scheme provides farmers with an effective tax linked savings mechanism that allows them to set aside pre-tax income from the good years to help them better manage their business during the more difficult years, thereby smoothing variable income flows.

The Scheme began in April 1999 replacing the Commonwealth Government's Income Equalisation Deposits and Farm Management Bonds. ABA advocated the commercialisation of the Government's schemes in 1996 making the point that the Government Schemes where poorly promoted and underutilised as a risk management tool. The FMD scheme is now in its ninth year and total deposits are currently around $2.7. billion.

In recent years there has been a distinct seasonality in the pattern of deposits, with a significant net inflow of funds in the June quarter and a corresponding large outflow in the September quarter of each. While this pattern is consistent the design of the scheme its has lead to the scheme being characterised as providing farmers with an option to later find a tax deduction to offset quarantined income.

Being tax effective it is logical that there will be a net accumulation of funds in June. Given the 12 month minimum investment period, a net drawn down of funds in the September quarter is consistent with holders accessing the funds as soon as they can for working capital requirements or to reduce debt in periods of unfavourable seasonal conditions.

FMDs are playing a significant role in supporting the recovery of farmers from drought conditions.

There are approximately 41,000 holders of FMD accounts with around 70% of FMDs held by broad acre farmers.

FMDs are highly competitive with at least 12 financial institutions providing the FMD products (see table below).

Amount: $10,000.00

Company Edit List: @FMD - Agri Business

Parameters: FMD

21-Jul-2008	30	60	90	180	270	1 year		2 years		3 years		4 years		5 years	
Company Name	**days nom**	**days nom**	**days nom**	**days nom**	**days nom**	**nom**	**eff**	**nom**	**eff**	**nom**	**eff**	**nom**	**eff**	**nom**	**eff**
Adelaide Agribusiness						8.25NA	8.25								
ANZ Agribusiness				7.50		7.90NA	7.90	7.40NA	7.40						
Bananacoast Comm CU Agri						7.35NA	7.35								
BankSA Agribusiness						7.05NA	7.05	6.95NE	6.72						
BankWest Agribusiness						8.00NA	8.00								
Commonwealth			6.40	7.25	7.25	8.10NS	8.26	7.50NS	7.64						

Bank Agri															
Elders Rural Bank Agri			7.00	7.50		7.85NQ	8.08	7.85NQ	8.08						
nab Agribusiness	2.10	2.50	7.80	8.00	4.50	7.95NS	8.10	4.90NM	5.01						
Police Cu SA Agri						5.25NA	5.25								
Rabobank Agribusiness	6.50	6.85	7.00	7.75	7.20	7.85NA	7.85	7.50NQ	7.71						
St George Agribusiness						6.95NA	6.95	6.95NE	6.72						
Westpac Agribusiness	2.35	2.85	7.80	4.30	4.30	8.10NM	8.40	8.20NM	8.51						
STATISTICS															
Average	3.65	4.06	7.20	7.05	5.81	7.62		7.22							
Highest	6.50	6.85	7.80	8.00	7.25	8.40		8.51							
Lowest	2.10	2.50	6.40	4.30	4.30	5.25		5.01							
Range	4.40	4.35	1.40	3.70	2.95	3.15		3.50							
Source: CANNEX															

FMDs have shown that cash reserves can be an effective risk management tool in times of economic downturns.

FMDs are more attractive to farmers that have relatively higher variable incomes (large broad acre), primarily because of the tax link, than they are for farmers with lower or constant incomes (small and intensive industry farmers).

The $65,000 off-farm income cut off for eligibility to use FMDs may also be inequitable for small farmers. Over the last two decades Australian farming families have increasingly become dependent on off-farm income to maintain their standard of living. During times of financial hardship, off-farm income can moderate the effect of a reduction or variability in farm income. Small farms with lower incomes, rather than medium or larger farms, are more likely to be dependent on off-farm income.

The fixed off-farm income limit does not take into account the scale of operating costs that need to be protected by a risk management strategy. A better way of managing this issue may be to continue to only allow funds earned from primary production to be invested in FMDs but to not allow amounts deposited in FMDs to flow through as an offset to taxable off-farm income.

The ineligibility of farm businesses that are incorporated to use FMDs as a risk management strategy may also be inequitable and may conflict with policy that promotes farming as a business and also policy that promotes addressing intergenerational transfer issues.

While it is noted that beneficiaries of discretionary trusts are eligible to use FMDs, many farming families also trade as incorporated entities as a strategy to manage intergeneration transfer issues. The limited liability of a corporation facilitates entering into share or joint venture arrangements that would not happen unless the assets of the individuals are protected. Another example of this is neighbours entering into joint venture arrangements to gain the benefits of economies of scale without putting their private assets at risk of the joint venture or the need for one to buy the other out.

Incorporated entities that earn significant off-farm income could be restricted in using FMDs in the same way that individuals are restricted.

Having a fixed limit ($400,000) on the amount of funds that can be held as FMDs also does not take into account variation in farm scale or optimal farm scale of mature agribusinesses. If limits need to be applied to FMDs then they should relate to average costs of annual production per business.

Farmers should also be permitted to have FMDs with multiple financial service providers. It may suit farmers to have a portfolio of deposits made up of different terms, including at call. Farmers should be free to shop around to diversify their deposits as this would encourage further competition and further product development.

Consideration should also be given to extending access to FMDs to rural businesses, such as farm machinery dealerships, fertiliser suppliers, and farm service contractors, that are significantly affected by downturns in agricultural industries.

Recommendation 7a: ABA recommends that the Government should retain the FMD scheme and moderate the restrictions on:

- **eligibility of farm businesses,**
- **volumes that can be deposited, and**
- **deposits being held at multiple financial institutions.**

Recommendation 7b: ABA recommends that the Government also consider extending FMDs to rural businesses that predominately provide services to farm customers.

5. Impact of drought on the welfare of farmers and rural communities

While Australia's most recent drought has been described as the most severe in 100 years, drought is a relatively regular event and climatic risk is an inherent feature of farming. However, drought can have a devastating effect on individuals and take a toll on rural communities.

Managing drought can create significant stress regardless of whether a business is at financial risk. Stress, overwork and reduced time for family and community activities due to drought management activities can affect the wellbeing of farmers and their families. Where a business is not financially well placed to manage drought, stress is compounded by having to cut costs affecting the day-to-day lives of families.

The reduction in the number of farms and farming families has been one contributor to the population declines in the small towns that have traditionally serviced the farm sector. At times of adversity reduced access to community can heighten the impact of relative isolation on farmers and their families. Local access to financial and social counsellors and strong community leadership has an important impact on how well a local area copes with drought conditions.

Farmers and other rural business people may need help obtaining the finance they require and assistance to understand and apply for the financial assistance they are eligible for. They may also need an objective third party to help them understand why, in some circumstances, it would be irresponsible for a lender to extend further credit when they will not be able to service the debt on commercial terms, even after a break in the drought.

It is important that the role of Financial Counsellors extends beyond being advocates for their clients and that they are capable of providing advice that is genuinely in the best interests of their clients.

Farmers requiring welfare support payments (Farm Help) should not be required to seek sign off from their bank that it is not willing to provide further financial accommodation

Recommendation 12: ABA recommends that Government support for local financial and social counsellors needs to be maintained.

Recommendation 13: ABA recommends that Financial Counsellor services be expanded to ensure access is available to support for farmers in conducting constructive discussions with their financiers regarding carry-on finance and/or credit policy during drought episodes.

Recommendation 14: ABA recommends that welfare payments continue to be made available to farmers during times of drought.

Recommendation 15: ABA recommends that banks should not be placed in a position where they are seen as assessing eligibility for welfare assistance.

6. Assisting preparation for drought

7. The use of tax/grant incentives

The impact of the current drought has very severe on irrigators where the availability of water has been significantly restricted.

Recommendation 8: ABA recommends that Government incentives that make investment in more efficient water use technology commercially viable should be explored.

7.1 Income contingent loans for drought relief

Customers that are viable in the long-term should not have a problem restructuring loans and accessing short-term carry-on finance in drought conditions.

The management problems for farmers who have economies of scale that are below optimal industry standards can be compounded by drought assistance that weakens the long-term capital structure of their business.

Unless additional debt is underwritten or guaranteed by an external party or it has second order security priority to existing lenders, it will further undermine the creditworthiness of the businesses, increasing the credit risk of current lenders. Even if interest is only payable after other financial commitments have been met the additional loan will impact upon the loan to value ratio of existing lenders if their security position is compromised.

However, there is scope for commercial finance institutions to extend finance beyond normal commercial terms and conditions if these borrowings are underwritten or guaranteed by an external credit worthy entity. There are a range of ways this could be done. For example, this could be via a specific fund that is guaranteed by Government or by a straight Government guarantee. A Government guarantee will ensure that the prudential cost of providing the loan is below normal commercial cost and these savings could be passed on to the farmer. The Government guarantee would also ensure that the terms and conditions of ongoing access to commercial finance are not affected.

The provision of finance under such a scheme would need to be balanced by the individuals' prospect of being able to pay additional interest.

Recommendation 9: ABA recommends that interests of existing commercial lenders would need to be protected if additional credit is to be extended beyond normal commercial terms.

7.2 Training

Farmers need access to high quality education regarding prudent risk management. This is especially the case for farmers that are looking to invest to improve their self reliance.

Recommendation 10: ABA recommends that Government continues and expands training that encourages conservative business planning and understanding of options available to manage drought.

7.3 The adequacy of research on climate variability and its impacts on agriculture

The ability to gauge the risk of success of a forthcoming production season before incurring the costs of production is of significant benefit to managing production risk.

Current practice in most instances is to sow the crop when soil moisture profiles permit.

Recommendation 11: ABA recommends that further research on climate variability and its impacts on agriculture be supported including its extension to farmers.

8. Conclusion

ABA supports the Government's current general policy setting on drought and believes EC parameters can be adjusted to take into account climate change. The ABA's objective in making this submission is to assist Government improve its implementation of its policy. Our submission identifies impediments to its success, some possible ways to address these issues as well as, improvements to the way assistance is provided.

Very few farmers leave the industry during financial downturns such as drought. Government assistance plays an important role in ensuring that the exit of farmers from the industry is orderly by relieving pressure to sell assets in the middle of drought. The number of farmers leaving agriculture is greatest during relatively good times when land values are high and neighbouring farmer have the financial capacity to expand. Government assistance during drought helps preserve the equity of farmers needing to leave the industry, which maximises the options available for them after farming and helps to protect their dignity.

ABA identifies 3 separate target groups for government assistance in times of severe drought which need different forms of government assistance.

- farmers, including young farmers growing their business who due to their debt levels are vulnerable to the risk of severe drought
    - interest rate subsidies but could also include grants for specific projects relating to drought management
- mature business of appropriate scale and equity
    - FMD's to assist them build and easily manage liquidity reserves
- Small inefficient businesses that are unlikely to be viable going forward
    - Welfare and exit grants