

THE NEED FOR MEDIUM TERM CREDIT IN THE RURAL SECTOR AND THE RURAL BANK'S ROLE IN MEETING THIS IN THE MARKET PLACE

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PART I THE RURAL CREDIT MARKET

1 INTRODUCTION

1.1 This paper looks at areas of rural lending where there would appear to be an unsatisfied demand for credit and considers the possible role the Rural Bank could play in meeting this demand with funds which it can raise from the marketplace.

1.2 In looking at any possible Rural Bank role it is necessary to look at the bank's development and attempt to project where the bank may be heading. At the time of compiling this paper a general election was only a matter of weeks away and it is apparent that a change of Government could have a very major impact on the bank's short to medium term direction. This factor also highlights that in looking at the Rural Bank's role the policies of any present and future Government are going to have a major influence on that.

1.3 This paper represents the views of the writer and does not reflect opinions or statements made by Rural Bank management.

2 RURAL CREDIT NEEDS

2.1 Before looking at areas of demand it is necessary to look at the range of rural credit needs. These can be broadly categorised into the following major needs:

- Land Purchase
 - workers' holding/part time units
 - first economic unit
 - additional land
 - subsequent economic unit
- Land Development
- Stock
- Plant and Machinery
- Refinance
- Seasonal Finance
- Processing and Marketing

2.2 The type of finance required for each of the above categories will vary depending upon the strength of any individual farming venture but as a general rule the following terms would be sought:

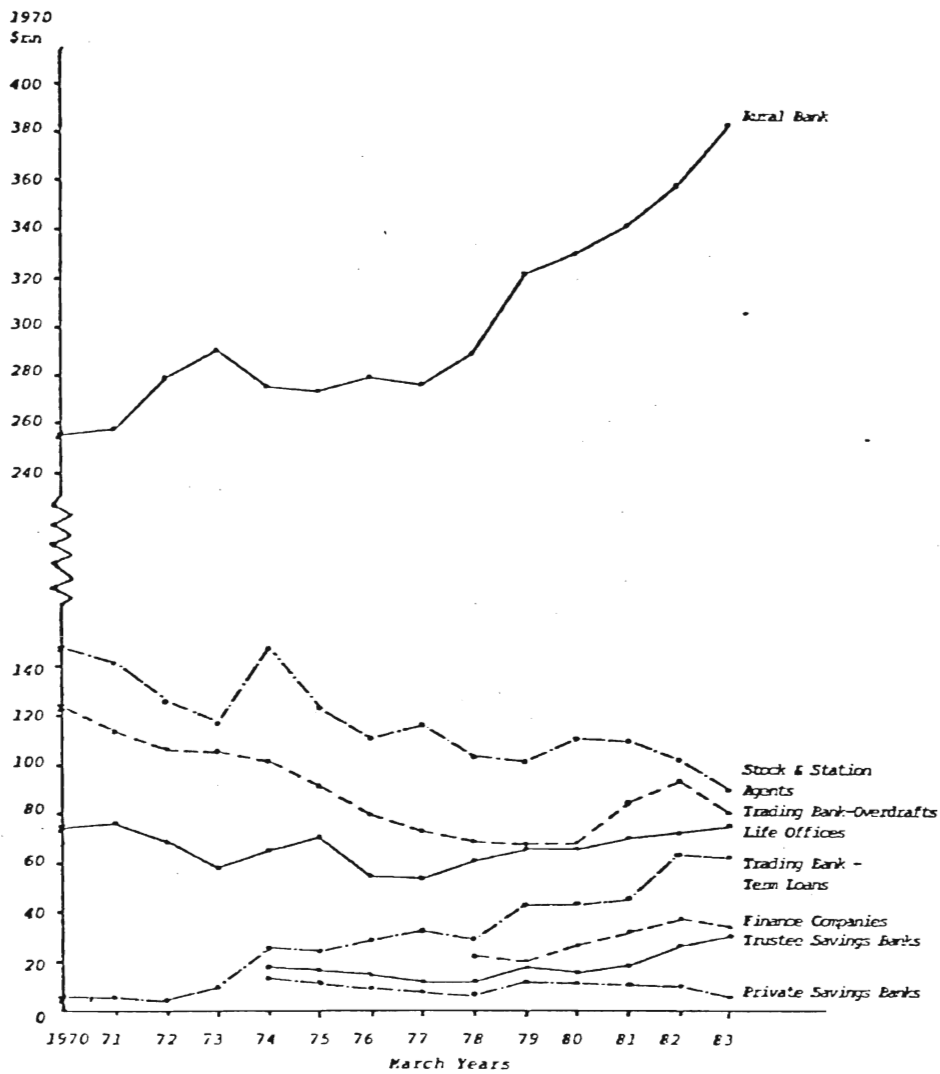
Land Purchase	- medium to long term
Land Development and Refinance	- medium term
Stock	- varies as to the purpose for the stock purchased
Plant and Machinery	- short term
Seasonal Finance	- current account
Processing/Servicing Industries	- short/medium term

3 CURRENT SOURCES OF FINANCE

3.1 Listed below is the range of institutions and others who currently lend in the rural sector. The average lending term noted beside each source was obtained from the Meat and Wool Board's 1980 Sheep and Beef Farm Survey. These have been included as a guide to the terms available.

Source	Average Term Years
Rural Bank	21
Lands and Survey	27
Other Government	25
Local Body	21
Trading Bank	9
Stock Firm	10
Insurance Company	20
Finance Company	3
Building Society	19
Trust Company	4
Solicitor	4
Vendor	8
Family	10
Others	8

3.2 The above table has been expanded further to show the percentage of rural lending each undertakes. This table was extracted from the Lincoln Research Unit paper "The State of Agricultural Credit in New Zealand" and shows the lending of institutions adjusted to 1970 dollars.



4 ADEQUACY OF CURRENT SOURCES

4.1 It is difficult to gauge whether or not the present sources of credit are adequate. Present poor returns for some farmers together with an easing in the value of farm land may be restricting some farmers desire to borrow. Furthermore, regulations introduced during 1983 restricting the rates at which loans can be offered together with regulations in 1984 affecting the borrowing rates for institutions may have an effect on the amount of funds available.

These factors must be noted as having a bearing on current demand and availability.

4.2 Putting aside the factors covered above, there do appear to be several areas where there are possible shortages. A paper titled "The State of Agricultural Credit in New Zealand", completed in 1983 by the Lincoln College Agricultural Economics research unit included amongst its conclusions that "there still appear to be sectors of the credit market where supply is a significant constraint". These areas were cited as:

- "(a) In real terms the amount of short term finance available from stock and station agents and trading banks has declined significantly over the past decade. This is despite higher levels of stocking and farm inputs.
- (b) Long term finance from private institutional lenders is in short supply. Farmers who do not qualify for Rural Bank finance are considerably disadvantaged."

This paper also cited the cost of credit as being of major concern to farmers.

4.3 The cost of credit is an important factor which must not be overlooked in considering the availability of credit. If credit is readily available but at rates and on terms which create an unacceptably high level of debt servicing this then effectively becomes a constraint on the availability of credit. This factor is even more critical where debt restructuring or refinancing of hard core debt is being undertaken.

To be of any use the farmer must be able to acquire the credit on terms which enable a lower level of debt servicing.

4.4 The Rural Bank itself does not have unlimited funds available and each year a significant proportion of the total applications received by the bank are declined. Over the last four years the number and amount of applications declined as a percentage of the total number received is as follows:

	<u>Number</u> %	<u>Amount</u> %
1979/80	10	16
1980/81	12	17
1981/82	19	27
1982/83	19	24
1983/84	13	20

These statistics only represent formal applications received by the bank but a considerable number of informal approaches which are made would be discouraged before an application has been completed.

4.5 Over the last two years the greatest number of farm loan applications declined were requests for land purchase and land development. As a percentage of the total farm loan applications declined these represented:

<u>Purpose of Loan</u>	1982/83		1983/84	
	<u>Number</u> %	<u>Amount</u> %	<u>Number</u> %	<u>Amount</u> %
Development	42	26	34	18
Land Purchase	32	59	38	67
Stock Purchase	8	4	11	4
Refinance	10	7	9	7

The bank categorises its declines into funds, viability and policy. Policy to a large extent could be deemed to be funds as policy is significantly governed by available funds. Therefore, declined farm loan applications which could be largely attributed to a lack of funds were:

	<u>Number</u>	<u>Amount</u> (\$m)
1982/83	1907	115.79
1983/84	1108	75.75

4.6 The high demand for land purchase funds could be related back to the lack of longer term loans available from other institutional lenders and with the bank being the only significant source of these funds it would, in a large number of cases, be the first institution approached where applicants consider they come within the scope of the bank's policy. However, increasing land prices have placed considerable pressure on the bank's ability to continue to provide effective settlement loans to as many young farmers as it has in the past and this situation will possibly get worse.

4.7 The demand for development funds is more a reflection of the increased requirement for funds generated by the intensification of land use, particularly through horticulture and the increased demand for irrigation. In recent years this demand has been further increased by requirements associated with the Land Development Encouragement and Livestock Incentive Schemes. While these schemes have terminated there are ongoing requirements for backup finance associated with the initial development programmes. In so far as horticulture is concerned, the rapid expansion of this industry has generated additional demands on existing funds, particularly from the kiwifruit industry, and is generating further finance requirements to help meet the capital costs associated with post harvest packing, storage, processing and marketing requirements.

4.8 While the bank's statistics do not reflect refinance as a significant area of demand this is probably more attributable to the limited funds (outside special lending schemes) that the bank has had available for outlay in this area. Notwithstanding this, prevailing climatic and economic conditions have left many good farmers with fragmented borrowing and high commitments. The need of those farmers is for restructuring assistance on terms that can be of real benefit in reducing the level of debt servicing.

4.9 To summarise, any need for rural credit would appear to fall into the following areas:

- Seasonal Finance
- Debt Restructuring
- Land Purchase
- Land Development
- Processing and Marketing

PART II THE RURAL BANK'S ROLE IN THE MARKET PLACE

5 THE RURAL BANK'S TRADITIONAL LENDING ROLE

5.1 The Rural Bank was established in 1974 when it took over from the Rural Division of the former State Advances Corporation which in one shape or another had been lending for housing and farming for the best part of the current century.

At the time of its creation the bank's role was primarily in lending for the settlement of first time farmers on an economic unit and for productive development. Limited assistance was provided for debt restructuring. Land purchase and development together with assistance to rural and fishing industries provided the bulk of the bank's lending of \$103.17 million in the 1974/75 year.

5.2 In the intervening years this role has been expanded with land settlement now covering uneconomic stepping stone units to farm workers, special settlement loans of up to 85 percent of land and stock, loans for irrigation, plant and machinery loans, a wide range of development assistance including assisting part time farmers as well as a range of special schemes which have been introduced during these years. Some continue such as the Farm Vendor Finance Scheme, Rural Resource Development Zones, Farm Ownership Savings Scheme while others which are no longer the subject of new advances continue to be administered; eg, Livestock Incentive Scheme; Land Development Encouragement Scheme.

5.3 Loans advanced since 1974 are as follows:

	<u>Loans Granted</u>		<u>Applications Received</u>	
	<u>Number</u>	<u>Amount</u> \$(m)	<u>Number</u>	<u>Amount</u> \$(m)
1974/75	7615	103.17	10846	151.10
1975/76	9663	139.26	11216	201.10
1976/77	7524	154.34	10978	263.44
1977/78	11708	227.90	14102	337.84
1978/79	13775	292.89	17387	420.93
1979/80	12436	306.93	16299	471.07
1980/81	13933	369.69	19261	623.87
1981/82	15540	464.62	19158	721.25
1982/83	13351	443.62	13416	650.78
1983/84	10557	390.36	12764	634.26

As at 31 March 1984 the bank's mortgage assets stood at \$2,275 million.

5.4 The bank's annual lending is funded approximately (there are annual variations) 60 percent by borrowing from the Government with 40 percent being met by mortgage repayments. A Government subsidy is received for the difference between the bank's cost of borrowing and the rates at which it on-lends the funds (for the last financial year this was .06 percent of the total mortgage assets).

5.5 Despite the steady increase in the level of funding for the bank it was still not able to satisfy the level of demand. In fact if inflation is taken into account the effective level of assistance has probably not increased and this is reflected in the number of applications not fluctuating significantly during the decade, particularly when special schemes are discounted from the table set out in paragraph 5.3.

5.6 In 1982 Government agreed that the bank should be able to exercise the option contained in the Rural Banking and Finance Corporation Act to raise funds from the public. This was seen by the bank as a means by which a greater level of assistance could be injected into the farming sector.

6 EXPANSION OF BANK'S FUNDING BASE

6.1 The bank put its first public issue together during the later stages of 1983 and this opened for subscription in February 1984. It was very successful with \$25 million being raised in a little over a week.

6.2 These "private" funds were raised on the assumption that the bank would establish a commercial wing and the operation would be run on a strictly commercial basis. The funds would not form part of the then current lending operation of the bank but would be used to assist those worthwhile ventures which because of their strength would not normally qualify for loans at concessional rates. The bank also undertook to lend in some areas where it had not previously become involved, eg, replacement plant and machinery.

6.3 Funds raised are on-lent at market rates which are set at a level sufficient to meet the bank's own cost of borrowing and operating expenses for the commercial division. The repayment terms are set bearing in mind the average term of the bank's own borrowing and as a consequence, initial terms have tended to fall at the shorter end of the market. As a broader funding base is established I would expect the repayment terms to become more

flexible with a larger percentage of loans (than at present) being given terms in the medium range.

6.4 In establishing the commercial division the bank has also endeavoured to improve its handling of applications and achieve a shorter decision time for the applicant. Overall, a speedier and more flexible operation was established.

7 THE FUTURE LENDING ROLE OF THE BANK

7.1 The Rural Bank is the major source of long term finance and there is no reason to believe that any other non Government institution will ever assume that role. A major role of the Rural Bank must continue to be to maintain the availability of longer term finance to good establishing farmers who would otherwise be unable to attain land ownership and/or maintain or increase the productive capacity of their properties without it.

7.2 The bank should also continue its role in providing disaster relief loans and be the institution through which special Government lending schemes are implemented.

7.3 The expansion of the bank's funding base does, however, provide the bank with a possible expanding source of funds with which it could consider an even greater level of assistance to the farming industry provided of course there is a continuation of the availability of Government borrowed funds at around the equivalent of current levels.

7.4 Central Government is coming under increasing pressure from all sectors and with continued budget deficits it is looking at areas where the demand on Government funds can be trimmed. The Housing Corporation has recently announced that it will seek a substantial proportion of its annual funding budget on the open market and, that these funds will be in direct substitution for Government borrowing.

7.5 It is not unthinkable to expect that the Rural Bank could also be forced to raise a significant proportion of its current funding requirements in the same way. While this may or may not impact upon the rate of interest the farmer pays it must effect the bank's ability to continue to provide a substantial level of long term finance.

7.6 If the bank was required to raise a significant proportion of its current lending, plus any growth, on the open market this would have major implications for both the bank and its lending policies.

At worst, the bank could be looking to raise all its funds from a very competitive and already tight money market. Even to raise half of its current funding requirements would require a sophisticated and diverse range of instruments in the market place not to mention a considerably enlarged fund raising division. This would mean a higher level of operating costs.

The ability of the bank to continue to be able to offer longer term finance at current levels would depend upon the type of funds raised. Certainly it is hard to imagine the bank being able to establish a borrowing base which would enable it to continue to offer terms in the 15 to 25 year range to the current extent.

7.7 A higher level of repayments would be required in order to keep the annual borrowing requirements within manageable proportions.

7.8 However, this paper will assume that any funds raised by the bank can be treated as additional to current Government sourced funds and will be used to consolidate and expand its commercial activities.

7.9 Because these funds are being on-lent on a strictly commercial basis quite separate from the bank's established policies, they will not result in any increase in the availability of long term finance for reasons already outlined. It is probable that in the first year or two that the average term of commercially based funds will fall at the top end of the short term category. As a stronger cash flow is established a greater percentage of the lending should attract medium repayment terms and I would expect the average term to fall within the medium range.

Bearing the above factors in mind it becomes a question of what type of lending these funds should be directed into.

8 POSSIBLE LENDING OPTIONS FOR COMMERCIALY RAISED FUNDS

8.1 Earlier in the paper I raised five areas where there appeared to be an unsatisfied demand for credit and I now propose to look at these in relation to any additional bank funding. These should be looked at in the light of the bank's stated prime objective of achieving expanding export earnings through investment in farming, fishing and primary industries.

(a) Seasonal Finance

It cannot be overlooked that the expansion into horticulture will create additional demands for seasonal finance and there may be greater pressure brought to bear on the bank to undertake some increased role in this area. Furthermore, existing suppliers of seasonal finance have indicated increasing pressure on their ability to meet current demand. However at an annual funding level of \$25 to \$50 million, unless the bank was prepared to commit all or a significant proportion of those funds to this purpose any amount made available would be insignificant. Furthermore, the present method of raising funds through a retail type stock issue would not be appropriate to funding a seasonal finance operation and the bank would need to undertake a higher and more sophisticated level of fund raising.

The provision of seasonal finance would not contribute to the drive for increased exports but would largely be a shift of funding source from existing suppliers of seasonal finance to the bank. From a purely operational point of view, seasonal finance would make funds management very difficult. Given the present volume of commercial funding seasonal finance would not appear to be an appropriate area for on-lending.

(b) Debt Restructuring

At a glance debt restructuring would appear to be an ideal area into which commercially raised funds could be channelled. However, at present the terms being offered are very much at the short end of the scale and certainly a more flexible approach as to the repayment term would be necessary. Given present funding levels and the youth of the commercial operation it would be undesirable for the bank to undertake any substantial amount of debt restructuring where a longer term in the region of 10 years was required. However, as a stronger cash flow is established and the funding base becomes broader so it would be possible for a greater role to be played in this area.

A more immediate possibility would be to shift some of that lending currently funded through Government sourced funds into the commercial area and use those funds released to play a greater role in debt restructuring offering longer terms. Whatever option is used, debt restructuring should be restricted to assisting good farmers who have the ability to maintain or increase the productive capacity of their property with the aid of such assistance. It should not be

used to prolong the sale of properties in the hands of poor farmers.

(c) Land Purchase

While the unsatisfied demand for settlement loans grows, this is not an area where I would see the direct channelling of commercially raised funds. This area of lending has been one of the traditional areas of strength for the bank in that it has provided long term finance to those young farmers who would often otherwise not have the ability to obtain land ownership. The demand is for long term finance on terms which I would not see the commercial operation being able to provide. If there is any role it may be in providing assistance supplementary to any main mortgage which has been raised long term.

I see the bank's primary lending in the area of settlement as being dependent on the availability of longer term Government sourced funds. Like refinance, some increased direct lending could be obtained by moving some of the more 'commercial' lending carried out from Government sourced funds into this new area.

(d) Land Development

The ongoing demand for funds from the traditional types of farming and the increasing demand from a growing diversity of horticultural and other types of farming will no doubt place even greater demands on the traditional sources of funds. For the Rural Bank, development lending would appear to be tailor made to its commercial operation. The repayment terms required vary but the majority probably fall within the medium range.

Development projects would generally be undertaken because they offer the farmer the prospect of some increase in income. This basic objective is common to a commercial enterprise.

Because such projects are undertaken for "commercial reasons" it is reasonable that they should be funded on a more commercial basis than currently (through the Rural Bank). In fact, as an option some of the development projects assisted through the Government sourced funds could be funded on a commercial basis thus making available a greater amount of the Government funds for such purposes as debt restructuring or land purchase.

The bank has in the past been reluctant to provide assistance for plant and farm machinery, particularly where this was replacing existing items. Given the more commercial basis for lending the bank could consider greater assistance for this purpose.

(e) Processing and Marketing Industries

The bank has always been involved in lending to processing industries and, like development projects, on terms which are considerably more favourable than they would be able to raise from other sources. Like development projects assistance to processing industries probably could be funded from commercial funds thus releasing Government sourced funds for other priority areas.

However, even without considering the above, there will be a significant demand for funds, particularly from those developing sectors, for "post harvest facilities". These tend to be capital intensive and could require large sums over the next five years. Similarly, these newer products will require to be promoted in order to establish markets. While lending for marketing would be a new area for bank assistance I would see it as being in sympathy with the earlier stated objective and provided normal lending requirements as to security, payability could be met this would be a suitable avenue for funding.

9 CONCLUSION

9.1 The role the Rural Bank will play in meeting the demand for rural credit will depend upon the direction any future Government desires to see the bank head. Should that direction be for the bank to raise the bulk or all of its funds from the money market then there would need to be a change in the structure of the bank with a more sophisticated fund raising division being established and the bank would need to have the ability and discretion to be able to more freely compete on the money market. All lending by the bank would need to be on a more commercial basis with the interest rates being at market levels and the average repayment term trimmed. Any increase in the availability of funds to the rural sector would be directly related to the bank's ability to raise funds and of course any Government constraints which may from time to time be imposed.

9.2 Should funds raised on the open market be a supplement to existing Government sourced funding then the bank could consider directing these into development, processing and marketing industries. However, it would appear that a review of the entire

lending operations of the bank was now appropriate with activities being identified as either, (a) commercial, (ie, the Rural Bank is simply another source of funds which would have no particular advantage over other institutions) or, (b) concessional (the bank lends in areas which are unattractive to other institutions, long term settlement, restructuring loans, loans to good but struggling farmers).

9.3 Whatever the approach it will need to be carefully considered and planned. Any additional funds available through the Rural Bank should not be utilized in such a way as to result in other institutions reducing their involvement. The net result to farmers of that situation would be nothing.

References:

- Rural Banking and Finance Corporation Annual Reports
- The State of Agricultural Credit in New Zealand -
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