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GOVERNMENT RESPONSE TO THE  
2012 COOK ISLANDS BANKING REVIEW  
AUGUST 2013

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## Background

Banking is a crucial aspect of any economy. The efficiency and effectiveness of the financial system is a key to underlying economic success.

Banking is made up of two main business lines. The largest of these is known as intermediation. Intermediation is simply the taking of deposits and then lending them on to other parties. At its most basic, intermediation by banks (i.e. deposits and lending) enables those with excess resources for their needs today to pass them safely on to those who could benefit from access to more resources in their lives or businesses.

The other business is payments. The payments business is the transferring of money between people or organisations in different physical locations. Historically, this involved cheques and cash, however payments is where technology has really changed the face of banking. Electronic settlements and internet banking have revolutionised the way modern banking is now done.

The most critical banking services for the Cook Islands today are:

- cost effective lending products that match business and personal needs and risks; and
- high functionality of electronic payment and money-management internet banking platforms that are directly linked into global payments networks.

Following the recommendations of the Economic Task Force to undertake a review of the banking system the Government commissioned Sam Knowles to undertake a review of the Cook Islands banking system. In particular Mr Knowles was asked to undertake a review which would define a long term strategy for the provision of banking services for the Cook Islands economy that would on a sustained basis:

- lower the cost of banking for businesses operating in the Cook islands;
- improve the accessibility to banking by Cook Islands businesses and residents;
- provide the banking services necessary to support the major growth sectors of the economy; and
- minimise the need for Government financial support to achieve the above.

The key conclusions of the review were that the:

- Cook Islands banking system is operating on a developing country model, whilst business customers have developed country needs and expectations;
- low scale of the banking systems makes it a high cost model;
- profitability of the banking sector is relatively low, and is possibly at unsustainable levels;
- banking system has a significant non-performing loan problem that is a major drag on the economy; and
- structure and operation of the current suite of property legislation is the major underlying cause of high bank lending rates

The review outlined that action to address all these issues would be required if the Cook Islands banking system is to contribute towards the restructuring of the economy so that there is continued sustainable growth.

The Government wishes to move forward with the second phase of the review. Actions under this phase involve coordinating specific activities to be undertaken by different agencies of government, including the Financial Supervisory Commission, the Ministry of Justice, Crown Law and the Ministry of Finance and Economic Management.

The work of the agencies will be coordinated by a working committee consisting of the Heads of those three agencies, that is, the Financial Supervisory Commissioner, The Secretary of Justice, the Solicitor General and the Financial Secretary.

The key recommendations of the review cover both short and medium term strategies including:

- The establishment of a task force to work with the commercial Banks to focus on defining the actual stock of both non-performing and under performing loans and analyse the specific constraints preventing the banks from taking action on these loans.
- Reducing the cost and complexity of selling a property lease and registering a mortgage against that same lease. This will be conducted within a consultative framework and will a comprehensive discussion with landowners on any changes to provisions. It should be noted that the Government will not change existing contractual obligations.
- To commence drafting an insolvency Act to deal with both personal and corporate insolvency.
- Undertake a cost benefits analysis on implementing the framework for a credit bureau to operate alongside the estimated usage by Cook Islands Banks.
- Not re-establishing a development financing facility, as the review believes there are significant risks to the Crown with the establishment of such a facility, and that risks associated with development finance must remain within the private sector.
- Seeking further advice in regard to changing bank licensing to encourage the banks to move towards a model that provides customers access to the scale and range of services provided by the New Zealand and Australian banking system.
- Undertaking a review of relevant land legislation that considers how to best establish a property category that is better aligned to the banking requirements for securing loans while still preserving the cultural significance of landownership.

The Government has considered the conclusions and recommendations and now wishes to respond publically to them and move forward to the next phase of the review. The response to each of the recommendations has been provided in more detail below.

## Detailed recommendations

### **Recommendation 1: Establish a task force to fully define the non-performing loan problem**

A non-performing loan (NPL) arises when the borrower has stopped making payments and the bank has stopped accruing interest. A loan is classified as an NPL when payments are overdue by three months or more.

NPL's in the Cook Islands are estimated by the FSC to have reached 10.3 per cent of total lending in 2011, a significant increase on the one per cent level of NPLs experienced in 2006.

Some of this increase is attributable to a fall in the total loan pool in 2011 (so NPLs appear relatively larger as a proportion). However, in 2010 (before the decline in total loans) NPLs were still a substantial 8.2 per cent of the total loan portfolio.

The Banking Review estimates an even higher NPL ratio of around 16 per cent (~\$45 million) in 2011. For context, the NPL ratio in Australia in December 2012 was 1.5 per cent and New Zealand was just over 2 per cent in 2012, with debt distressed countries like Greece and Ireland having 15.9 and 15.0 per cent respectively.

The impact of NPLs on economic prosperity cannot be understated. A high proportion of NPLs encourages banks to charge higher risk premiums on their loans (through the interest rate charges), or to curtail lending on riskier ventures (credit rationing).

Whilst it is difficult to quantify how much credit rationing has occurred, the Banking Review estimates that NPLs have added around 2 to 3 per cent to domestic lending rates.

Other impacts include:

- Continued reduction in property values – in turn reducing the amounts the banks are prepared to lend against property as a security.
- Very limited new construction activity due to the overhang of existing property for sale at below replacement cost.
- Further economic migration as indebted households seek new economic beginnings or higher income to service loans in New Zealand or Australia.
- Low bank profitability for a number of years. Money has been set aside (i.e. provisioned) to cover an expected capital loss of 35 per cent if and when NPLs are written off. If property values fall further this level may need to increase significantly with a corresponding impact on bank profitability.
- Lending interest rates increasing, due to the banks cost of carrying the NPLs and the increase in lending risk.
- Significant reduction on access to credit with both international banks making all major lending decisions outside of the Cook Islands using very conservative loan to value ratio criteria – maintaining further upward pressure on local lending rates.

Moving forward on this issue will require a facilitated partnership between the banks and government to address the issue of the current stock of NPLs.

The first step required is for all participants to gain a deeper understanding of the problem of the problem, by first defining and identifying the composition of the portfolio of leases and business assets that support these NPLs, and analysing the specific constraints which are preventing the banks from taking action on those loans.

The second step is to identify the strategies that could be employed by the banks to ensure the assets are brought back to full economic use.

It is important that the taskforce have terms of reference which are strictly defined.

Principally, the terms of reference must address the NPL issue in a way that is equitable to all stakeholders<sup>1</sup> and does not create moral hazard within the finance industry. Moral hazard is when, in fixing a problem, you encourage the problem to occur again because there is no incentive for people to change their behaviour.

Report Recommendation	Government Response	Implementation
<p>That the Ministry of Finance (MFEM) establish a task force with an independent Chair that includes:</p> <ul style="list-style-type: none"> <li>• the Financial Secretary;</li> <li>• the Banking Regulator;</li> <li>• a legal representative; and</li> <li>• the three Bank's CEOs (or their representatives).</li> </ul> <p>to fully define the problem and recommend within 90 days an action plan that would reduce NPLs below 5 per cent of loans within 18 Months.</p> <p>The Task Force would be serviced by staff from the Office of the Banking Regulator.</p>	<p><b>Agree</b></p> <p>The Government acknowledges the level of reported non-performing loans and the impact that this has on the stability of the financial sector.</p> <p>The Government would like to reduce the level of non-performing loans reduced.</p> <p>The Government will establish a task force with an independent Chair to look at the issue of NPL's.</p> <p>The Task Force will be chaired by an eminent person independent from Government and would include the Financial Supervisory Commissioner and a prominent legal practitioner.</p> <p>The Terms of Reference for the task force will be to work with the commercial Banks to focus on defining the actual stock of both non-performing and under performing loans, and analyse the specific constraints preventing the banks from taking action on these loans.</p> <p>The Financial Supervisory Commission (FSC) will act as the secretariat to the Task Force.</p> <p>The Task Force will report on a recommended way forward to the Government by beginning December 2013.</p>	<ol style="list-style-type: none"> <li>1. MFEM will draft the terms of reference for the Task Force, in conjunction with the FSC by 30 September 2013.</li> <li>2. The Government will select the Chair and members of the Task Force, ensuring that the chair is an independent party nominated by the Government.</li> <li>3. The FSC will act as secretariat to the Task Force.</li> <li>4. The Task Force is required to present its recommendations to the Minister of Finance three months after its establishment.</li> </ol>

<sup>1</sup> Stakeholders should be interpreted broadly: old and new borrowers, new and incumbent lenders, the Government, and the general public.

## **Recommendation 2: Reduce the cost complexity of selling property lease**

With a large portion of the landowner population now living outside the Cook Islands, the process for obtaining landowner consent is becoming increasingly difficult and expensive. Banks and their legal representatives comment that the lack of legal process for obtaining consent has led to a situation where the process of securing a mortgage over a lease, or moving to mortgagee sale, is very costly and takes an extended period of time.

This situation would be best addressed by prescribing standard consent processes in legislation that if followed could not be challenged legally (often called “safe harbour” rules).

<b>Report Recommendation</b>	<b>Government Response</b>	<b>Implementation</b>
Reduce the cost and complexity of selling a property lease and registering a mortgage against that same lease through amending the property laws to standardise the processes of obtaining consents of landowners.	<p><b>Agree in Principle</b></p> <p>The Government recognises the sensitivity and complexity of land issues in the Cook Islands.</p> <p>Any future approach by the Government will be conducted within a consultative framework and will involve a comprehensive discussion with landowners on any changes to provisions.</p> <p>Moving forward on this requires a standardisation of certain components within leases.</p> <p>Efforts will be made to ensure that current contractual obligations will remain as they stand.</p>	<ol style="list-style-type: none"><li>1. The Ministry of Justice, in consultation with other relevant stakeholders such as the Law Society, traditional leaders the LAT and MFEM, will review current arrangements around land mortgages for those islands under the jurisdiction of the Land Court and provide an action plan by the end of 2013.</li></ol>

### Recommendation 3: Establish bankruptcy provisions

There are currently no processes to enforce court orders to repay personal debt. Ideally, such processes relating to personal debt should include provision for an individual to declare bankruptcy in the event that they are no longer able to service their debts.

Bankruptcy processes also support the rehabilitation of the debtor so that after a defined period they can resume normal commercial activity. This enables residents to absolve themselves of their debts without becoming impoverished. This could also reduce the current incentive for individuals to informally absolve themselves by abandoning their liabilities and moving to New Zealand or Australia.

A Bankruptcy law would also apply to other forms of debt such as commercial accounts payable and tax arrears.

Report Recommendation	Government Response	Implementation
Improve the enforceability of lending contracts by establishing bankruptcy provisions or alternate court processes.	<p><b>Agree</b></p> <p>The Government concurs that the absence of a mechanism for residents to declare themselves insolvent and absolve themselves of debts requires redress.</p> <p>The Government will commence drafting an insolvency Act to deal with both personal and corporate insolvency.</p>	<ol style="list-style-type: none"><li>1. The Ministry of Justice will be responsible for drafting the policy and in conjunction with Crown Law drawing up relevant insolvency legislation.</li><li>2. The new insolvency act will be presented to Parliament in 2014.</li></ol>

#### **Recommendation 4: Establish a credit reference bureau**

Credit bureaus provide an information base on whether individuals have outstanding debts, the number of times they apply for loans, and whether they pay their bills in a timely manner. They are used by banks for loan approval and businesses that provide delayed payment terms to ensure they do not advance loans or credit to anyone who has a history of mismanaging debt.

With no bureau currently recording this information, individuals who have successfully managed past debts are treated on the same terms as those who have not, because lending institutions and companies have no visibility on credit history. Introducing a credit bureau brings the Cook Islands into line with developed economies around the world in providing fully integrated financial services.

To reinforce the incentive for individuals to manage their debts honestly, it is important that the new bureau be integrated with New Zealand and Australia and the provisions for the protection of privacy adopted. This would require a number of implementation steps which would include:

- establishing new legislation to allow the agency to collect information, ensuring consistency with New Zealand and Australia and coverage of the financial and non-financial sectors
- establish information sharing agreements with New Zealand and Australia in relation to credit histories
- finally, the establishing of the credit agency and registration of individuals

<b>Report Recommendation</b>	<b>Government Response</b>	<b>Implementation</b>
Banks establish a credit reference bureau preferably linked to an NZ based bureau so an individual's credit history would be available across both countries.	<p><b>Agree-in-Principle</b></p> <p>The Government will consult with local banks as well as the Australian and New Zealand credit reference bureaus to see how feasible it is to establish a connected agency here. Careful analysis will have to be undertaken to see what data sources could be made available for such a bureau to function.</p> <p>Assessments will have to be made on the scope of legislation needed to make sure such data is handled properly by a bureau and that the rights of the Cook Islands people are properly protected. The legislation will also have to cover how the bureau can collect data and what exactly it can do with it, as well as requiring procedures to ensure accuracy of the data held on individuals.</p> <p>As well as considering what legislation would be needed to operate a credit reference bureau there will also be consideration as to whether some form of Data Protection type legislation would be desirable. In the absence of a</p>	<p>1. The Government through the Financial Supervisory Commission will commence discussions with the banks in the Cook Islands to check the viability of such a bureau in the Cook Islands.</p>

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Central Bank or Office of Fair Trading type body in the Cook Islands, who in other jurisdictions normally regulate such bureaus, who would ensure such a bureau conducted its business properly will have to be considered. Such a body will have to be provided with the necessary resources and legislative tools to ensure such a bureau conforms to the Cook Islands requirements. Considerations as to whether that body is commercially run or a Government agency will also be considered.

A costs benefits analysis will be undertaken to judge the costs of implementing the framework for such a bureau to operate, against the estimated usage Cook Islands Banks would make of it.

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**Recommendation 5: The Government should not re-establish a development finance entity**

The Government agrees that the best way to address development needs is through prudent economic management and improving the business environment for commercial banking. Success in these areas reduces the need for a development financing entity, especially when there is adequate provision of public and aid funded infrastructure development.

The history of domestic development financing activity shows that the private sector can often assess investment decisions more effectively than the government. Public investment in private sector entities can often create a reallocation of public sector resources from productive to unproductive areas of the economy. Failed private sector lending by government can also burden public resources with extra debt servicing.

For these reasons, this activity is best carried on by the private sector.

<b>Report Recommendation</b>	<b>Government Response</b>	<b>Implementation</b>
That the Government should not re-establish a development finance entity.	<b>Agree</b> – The Government believes there are significant risks to the Crown with the establishment of such a facility, and that risks associated with development finance must remain within the private sector.	No further action

**Recommendation 6: Establishing a new class of branch license that allows for a fully integrated branch for a bank that has a New Zealand license**

As per the Banking Review, the prerequisites to this strategy are:

- broadband bandwidth and speed to allow Cook Islands to operate on a New Zealand based banking IT system;
- agreement with Cook Islands and New Zealand regulators, including confirmation that the Cook Islands is complying with all its international obligations for the supervision of banking and payments; and
- agreement with the Government of New Zealand on tax treatment for Cook Islands domiciled customers.

It would not be a necessary condition that the Cook Island branches of ANZ and Westpac integrate with their New Zealand operations, but it is assumed that they would move to the cheaper operating model over time.

Report Recommendation	Government Response	Implementation
Provide a first world banking capability by establishing a new class of branch license that allows for a fully integrated branch for a bank that has a New Zealand license.	<p><b>Agree in Principle</b></p> <p>The Government will research the implications of this suggestion and in particular consult with its current international bank licence holders. Particular focus will be on establishing if financial and technological impediments as well as customer base size are responsible for the lack of integration into the full systems of their parent entities.</p> <p>The tax implications will also have to be considered and discussed with the New Zealand and Cook Island tax authorities as to how such an arrangement can be accommodated between the two jurisdictions. The legal and political ramifications of allowing another jurisdiction to set the main regulatory functions for a financial entity established in the Cook Islands will be considered. Taking into account the reputational risk will remain with the Cook Islands. Early contact will be made with the New Zealand regulatory authorities to ensure they would be willing to co-operate with the Cook Islands in supporting such a license.</p>	<ol style="list-style-type: none"> <li>1. The Financial Supervisory Commission of the Cook Islands will lead on researching and coordinating a Governmental position regarding the implementation of this recommendation.</li> <li>2. The Financial Supervisory Commission will present its recommendations to the other members of the Review by the end of 2013.</li> </ol>

**Recommendation 7: Undertake a review of the Land Laws that considers how best to establish a property category that is better aligned to the banking requirements**

The issue of land use cuts across many areas of the Cook Islands economic and social fabric. There is a high cultural and social importance on domestic land ownership, but this system does come with an economic cost. There is substantial opportunity for the country to unlock more economic potential from local land (through agriculture and tourism) to provide better returns for landowners.

As the review points out, from a banking and business perspective, having most of the land with relatively short-term and non-standardised leases (with multiple individual owners and complex and uncertain approval processes) makes the Cook Islands a relatively unattractive place to do business.

In response to this issue, the Government proposes a Land Review to:

- fully review the current process for the on-selling of lease agreements;
- investigate the standardisation of lease agreements; and
- investigate the current allocation system and incentives facing landowners to productively use their land holdings.

This review will require broad consultation and community involvement.

Report Recommendation	Government Response	Implementation
Undertake a review of the Land Laws that considers how best to establish a property category that is better aligned to the banking requirements for securing a loan while still preserving the cultural significance of landownership.	<p><b>Note</b></p> <p>The Government will always maintain the Cook Islands hereditary system of land ownership.</p> <p>The Government will continue to maintain a leasehold system for land use.</p> <p>The Government acknowledges the difficulties which are now arising through the increasing number of Cook Islanders residing overseas who have occupation rights on land.</p> <p>The Government believes greater thought is required to ascertain if there is a need to have a separate property category, or extending the period of which a lease can be held to beyond 60 years, and also the consenting requirements</p>	<ol style="list-style-type: none"> <li>1. Together with Ministry of Financial and Economic Management, the Ministry of Justice will do a preliminary review of the issues involved in the area of land policy.</li> <li>2. A complete set of land policy issues will be presented to the other members of the Review by June 2014.</li> <li>3. The members of the Review will present their findings to the Central Agencies by June 2014.</li> </ol>