



Cook Islands banking

Reserve Bank of New Zealand

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Making sense of the numbers

In the decade up to 2020, the Cook Islands economy was performing at record levels. International visitors had peaked and Gross Domestic Product grew by 25 percent between 2015 and 2019. The Cook Islands economy was expected to continue growing and was forecast to have another record year. However, due to the global response to COVID-19, the economy has suffered greatly.

High local interest rates have long been a concern for the Cook Islands Government. The high cost of borrowing in the Cook Islands, compared to New Zealand, is seen as a “drag” on the economy. The vastly higher interest rates have been identified as having a large negative impact on economic development, forcing up the cost of living and doing business in the Cook Islands.

In 2012, Sam Knowles conducted a review of the Cook Islands banking sector to identify how banking could more effectively contribute to achieving economic growth. Knowles identified the nominal interest spread between the cost of deposits and the lending rate, for New Zealand and the Cook Islands, was around five percent. The spread remains similar in 2021 at approximately three percent for home loans and five percent for business loans. The observed margin (i.e. lending rate less term deposit rate) for housing is between 4.9 and 8.8 percent.

Knowles identified three drivers of the rate differences; offshore funding, scale and risk cost

Offshore funding

The strong performance of the Cook Islands economy has seen an end to the reliance on offshore funding and replaced it with domestic saving. However, scale and risk cost remain the core drivers of high interest rates. While small changes have resulted in improvements to the lending environment, concerns about interest rates are unlikely to be overcome without a significant intervention.

Scale

Issues of scale continue to keep the Cook Islands lending rates higher than those in New Zealand. The inherent cost of remoteness and a small population is not something that can be easily influenced by the Government or the banks. Three full service banks, ANZ, Bank South Pacific (BSP) and Bank of the Cook Islands (BCI), serve a market of less than 10,000 customers and about 1,000 businesses, preventing all three banks from achieving economies of scale.

The Cook Islands is well served by the three banks, but the islands are overbanked for the number of people they serve. Duplication is adding to the banks operational costs. This makes the cost of banking, and lending, higher than necessary. These higher costs are passed on to customers through interest rates.

Banks carry a relatively high number of staff per customer. In 2012, Knowles estimated that based on population ratios, the industry should employ 60-70 people. Total employment in 2021 was 189.

Risk cost

Banks have tightened lending practices and reduced the level of non-performing loans. However, the factors that influence the cost of risk have not changed greatly since 2012, and the perceived risk of lending in the Cook Islands remains relatively unchanged. The banks remain conservative on the back of previous economic shocks. The impact of COVID-19 has highlighted the risk associated with the Cook Islands reliance on a single industry, tourism.

Complexities of land tenure and the risks of default remain the greatest risk concern for lenders. Despite the recommendations made in 2012 land tenure and the lease system, that provides land as security for lending, remain the biggest difference between New Zealand and the Cook Islands operating environment. The laws in the Cook Islands make recovery of forfeiture difficult, slow, and expensive. Most freehold land in the Cook Islands can only be owned by Cook Islands families. A leasehold interest is one of the most common forms of land ownership. Individuals and businesses can own a leasehold interest in someone else's land for a maximum of 60 years, however the leases can be renewed at any time.

The risk cost of the land tenure system comprises four components that are incorporated into interest rates: certainty of title, the diminishing value of leases as security, the market for lease re-sale, and the time and cost of selling a lease.

- There is a lack of certainty due to the deeds system. Banks do not have the same guarantees they have in New Zealand. If an interest in land has not been properly identified and consulted the lease can be challenged and ultimately voided, rendering the bank's security worthless.
- The nature of leases is that the value diminishes as time passes, reducing the value of the security held and the possible value that can be recovered.
- Restrictions on residential property buyers limits the market for lease sales and restricts the value recovered from a mortgagee sale. The pool of potential buyers gets smaller as Cook Islanders can avoid buying a lease and can access their traditional family land at a much lower cost.
- The time to sell a lease and the costs associated with selling a lease are greater than in New Zealand. The average age of defaulted loans when they are cleared is three to five years. Meanwhile, in New Zealand they can be cleared almost instantly.

Land tenure is a contentious and complex issue that is politically sensitive. There is a lack of local support, or political will, for changing the land tenure system, making it unlikely that the 2012 recommendation to "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 land ownership" remains an option. It is unlikely to be acted upon.

Outstanding 2012 recommendations

There remains an opportunity to take action on recommendation two and "reduce the cost and complexity of selling a property lease and registering a mortgage against that same lease through amending property laws to standardise the process of obtaining consents of landowners".

Two further 2012 recommendations for taking action to reduce interest rates remain relevant for the Cook Islands Government.

- Recommendation three: Improve the enforceability of lending contracts by establishing bankruptcy provisions or alternative court processes.
- Recommendation six: Provide a first world banking capability by establishing a new class of branch licence that allows for a fully integrated branch for a bank that has a New Zealand licence.

Bankruptcy law is unlikely to reduce the risk of default by borrowers, therefore, the cost of risk included in the interest rate is unlikely to change.

It is unlikely that integration with New Zealand will have the desired impact. Since the Knowles review, New Zealand banks have shown little interest in the Cook Islands, citing the unique challenges of banking in the Pacific. If a New Zealand bank was to enter the Cook Islands market, this would further increase the costs caused by lack of scale by dividing an already small and overbanked market even further.

New Zealand banks are unlikely to take the risk in the Cook Islands when resources can be put to more productive uses in New Zealand. The differences from New Zealand mean the banks would most likely need to set up a specialist unit to offer the Cook Islands services, and would find it difficult to scale given the small market.

A 2020 report for the Cook Islands government, The Costs of Borrowing, recommends diversification to reduce interest rates. Diversification would reduce the Cook Islands reliance on tourism and decrease the market risk. However, there are limited opportunities for diversification, and tourism remains the most profitable use of land on the two most populous islands.

Next steps

This work is intended to inform further discussions of the policy, regulatory, operational and technical options available to the Cook Islands and RBNZ. Based on the actions taken in response to the 2012 review, The Costs of Borrowing report and interviews with stakeholders, we identify four areas where we see opportunities to promote the prosperity and wellbeing of Cook Islanders and reduce lending rates.

Reduce the impact of scale

In the absence of changes to land and property laws, addressing scale has the greatest potential to reduce rates. This was identified in 2012 and 2020 reports, and there was unanimous interviewee agreement that scale was a major factor in high interest rates. A banking partner from a big four accounting firm estimated that a bank in the Cook Islands would need to be $300-$400 million in size to be economic. If this occurred, and debt collection could be cleaned up, the partner estimated the margin could drop by two percent.

BCI has historically led with rate reductions, but has the least ability to spread costs. If BCI is to lead further interest rate reductions, it needs to increase its size, spread costs across a larger customer base and invest in systems to make processes more efficient. More Government contracts would support BCI to grow and would show that BCI can meet the needs of large customers.

Technology and new services present an opportunity to reduce operational costs while improving banking provisions to underserved parts of the community. The Asian Development Bank refers to the need for a state owned bank which would add value to the sector by providing new services or products, or providing access to underserved parts of the economy. With Government support, BCI could develop and promote the uptake of mobile and online banking, and the introduction of new services.

Better financial education

Improved financial literacy would reduce the perception of risk. If people better understood the impacts and consequences of their loans it would reduce the level of defaults. At a corporate level, businesses with improved governance have received improved loan rates from banks. If corporate governance could be improved, theory suggests that so would business performance.

Promote technology uptake

Technology is seen as a way to reduce the cost of banking. The county is in a position to increase online banking. If more customers were using online services it would reduce the need for branch services and enable banks to reduce these overhead costs, particularly for BCI. Support could be provided to promote the uptake of technology and online banking amongst the older population.

Promote alternative forms of lending

Alternative approaches to lending could be made available in the Cook Islands. Cook Islands deposits are greater than lending. For small lending Peer to Peer lending could bypass the banks and enable those with savings, to lend to those who need to borrow. If implemented correctly, returns for depositors could be greater than bank deposit rates and interest rates could be lower than bank interest rates. If lenders and borrowers could meet in the middle both would benefit. This would put pressure on the banks to improve interest rates. However, this comes with its own risks that need to be considered, including increasing the impact of scale.

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1 Introduction

High local interest rates have been a concern for the Cook Islands Government for over a decade. The high cost of borrowing, compared to New Zealand, is seen as a “drag” on the Cook Islands economy and is forcing up the cost of living and doing business in the Cook Islands. A vastly higher interest rate structure in the Cook Islands has been identified as having a large negative impact on economic development. Investment at current interest rates is seen as prohibitive, except for the most profitable investments.

The Reserve Bank of New Zealand (RBNZ) has emphasised its role, as kaitiaki of New Zealand's currency, to promote strong regional economies that support RBNZ's financial stability mandate.

Three realm countries, the Cook Islands, Niue and Tokelau, use the New Zealand dollar. Like most Pacific Island countries, the Cook Islands is facing challenges caused by climate change and the impacts of COVID-19. However, their banks cannot access RBNZ funding, or programmes that are intended to lower interest rates.

It has been suggested that a core strategic change, that would really make a major economic difference in the Cook Islands, would be for the Cook Islands banking system to operate under the auspices of the RBNZ, in a manner to be determined.

The Cook Islands Government has approached RBNZ for help with managing the effects of COVID-19 on the economy. One of the aspects of this work is to explore how closer financial integration between New Zealand and the Cook Islands could help improve the stability and efficiency of the Cook Islands banking sector and financial system.

The overarching focus of the work is to explore ways to promote the prosperity and wellbeing of Cook Islanders, through closer integration of the New Zealand and the Cook Islands financial systems.

To inform its work to support the Cook Islands, RBNZ has engaged Business and Economic Research Limited (BERL), to conduct a broad scan of the Cook Islands financial system which includes defining the problem, and identifying potential drivers of high lending rates.

This work will then be used to inform policy, regulatory, operational and technical options available to the Cook Islands and RBNZ. This will initially involve considering a full range of options, including (but not limited to) integration of the countries’ payments systems, alignment of the Cook Islands and New Zealand regulation and legislation, and regulatory reform.

1.1 Research Scope

The research consisted of the following elements:

- Identify and summarise the current state of the Cook Islands economy, and the outlook for the economy
- Collect and summarise available statistics on interest rates and credit provision in the Cook Islands, New Zealand, and other Pacific island countries, including lending statistics, and deposit rates
- Summarise the insights and recommendations from previous reports on the drivers of high interest rates in the Cook Islands economy, and the efficiency and stability of the Cook Islands financial system

- Collect banking sector statistics on the characteristics of mortgage and business lending and the financial position and performance of the Cook Islands banks, including the financial position of borrowers, collateral, size and price of loans, and default information
- Collect any available information of how many resident Cook Islanders and businesses have direct access to New Zealand bank credit – and how the characteristics of this lending compare to lending from the Cook Islands banks
- Consult with key stakeholders on their views of the drivers of high interest rates in the Cook Islands, and the efficiency and stability of the Cook Islands financial system, including views on the conclusions and recommendations of previous reports.

Stakeholders were identified by BERL and the Cook Islands Ministry of Financial and Economic Management (MFEM) and included the Cook Islands banks, government ministries, Cook Islands business leaders, representatives from real estate and legal communities, and the Financial Services Commission (FSC),

1.2 Report Structure

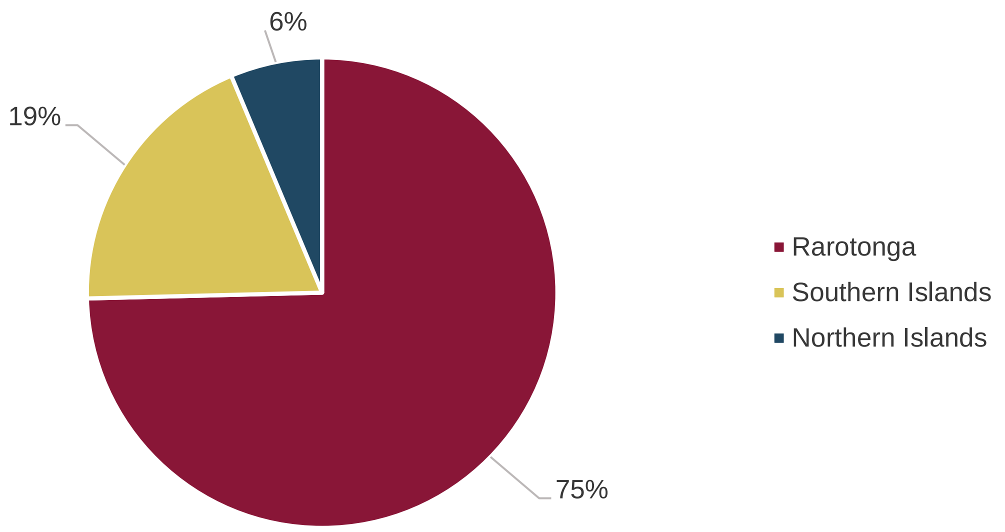
The report has five sections that address each of the elements of the scope above:

2) Current state of the Cook Islands economy
3) The Cook Islands interest rates in comparison to other Pacific nations
4) Banking in the Cook Islands
5) Drivers of interest rate differences
6) Recommendations.

2 Current state of the Cook Islands economy

The Cook Islands is self-governing in free association with New Zealand and its small population of 17,434, as of 2016, is spread across fifteen individual islands. The majority of the population (75 percent) is located on the largest island, Rarotonga, as depicted in Figure 2.1.

Figure 2.1: The Cook Islands population by island, 2016



Source: Ministry of Finance and Economic Management, Census 2016

The remaining population (25 percent) is spread across a mix of the northern and southern islands.

Due to Cook Islanders legally being New Zealand citizens there are large numbers of migrants from the Cook Islands to New Zealand each year as Cook Islanders seek better employment, education and income opportunities. In 2018, there was just over 80,000 Cook Islands Māori living in New Zealand.[1]

2.1.1 Employment and income

From the population of 17,434 in 2016, there was a total of 7,443 employed individuals.[2] The employment status of these individuals was as follows:

- 364 employers with employees
- 624 self-employed individuals
- 6,127 employees (full-time and part-time)
- 328 providing for family or volunteering.[3]

The Cook Islands economy is one-dimensional, built around services. In 2016, the top three industries, in terms of total employment, were service-related and accounted for a combined 52 percent of total employment:

[1] Statistics New Zealand (2018). *Cook Islands Maori ethnic group.*
[2] Ministry of Finance and Economic Management (2016). *Census 2016.*
[3] This comprises: in family business without pay, producing goods for own or family use, and volunteer work.

- Restaurants and accommodation, 1,556 people (21 percent)
- Wholesale and retail trade, 1,173 people (16 percent)
- Public administration, 1,115 people (15 percent).

The Cook Islands strongly depends on international tourism as the driver of its economic growth, and thus, a large number of employment opportunities come from the significant size of the Cook Islands service sector.

With such a small population, and the free association relationship with New Zealand, the Cook Islands economy constantly struggles with employment capability and capacity issues. Retaining skilled labour is inherently difficult in the Cook Islands as New Zealand provides more, and relatively better, education and employment opportunities that allow for better income growth. In 2018, 51 percent of employed individuals in New Zealand earned over $35,000.[4] In comparison, only 12 percent of employed individuals in the Cook Islands earned over $35,000 in 2016.[5] This substantial difference is one of the key drivers of outward migration from the Cook Islands.

2.2 COVID-19's detrimental impact on the Cook Islands

In the decade up to 2020, the Cook Islands economy was performing at record levels, international visitors had peaked, and so had Gross Domestic Product (GDP), with 2020 forecast to be another record year. During this period of significant economic expansion, the Cook Islands economy was able to build a level of resilience and strength.

However, no one could have predicted the unprecedented circumstances of COVID-19, and the severe impact it would have on the global economy, but even more so the Cook Islands economy. With such a one-dimensional economy, the impact of COVID-19 was instantly felt, and with no international visitors, the Cook Islands economy began contracting substantially. The extended period of economic expansion in the lead up to COVID-19, acted as a buffer to help minimise the overall impact. Some Cook Islanders described it "as good a time as possible" for COVID-19 to hit, given the level of strength and resilience in the domestic economy. But, the overall impact was still severe, with the vulnerability of having a one-dimensional economy focussed around international visitors fully exposed. Optimism remains in the economy and there is great hope that once borders re-open the economy will begin to start operating at full potential again, and the economic recovery can begin.

2.2.1 Limited visitors to fuel the economy

The Cook Islands economy is strongly driven by international tourists who fuel the service industry, and in the build up to 2019, total visitor arrivals were increasing consistently. In 2019, total visitor arrivals peaked at 171,550, as depicted in Figure 2.2.

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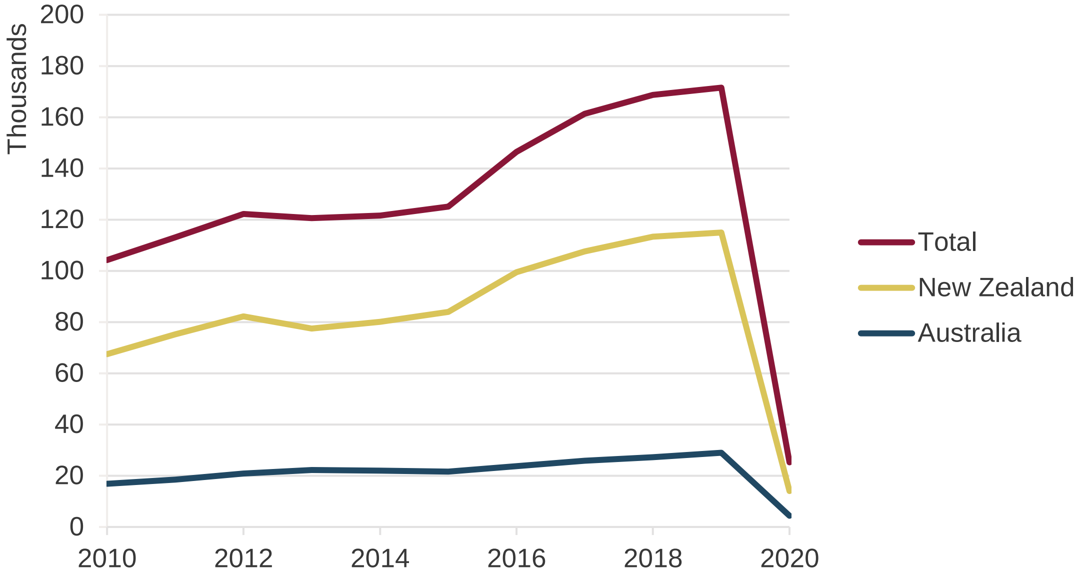
4 Statistics New Zealand (2019). *Total personal income, work and labour force status, and ethnic group (grouped total responses) by age group and sex, 2013 and 2018 Censuses*.

5 Ministry of Finance and Economic Management (2016). *Census 2016.*
Note: Due to differences in data collection processes, the ability to compare income levels in the same recorded year was not possible. However, this comparison still reflects a significant difference. Please see Appendix A for data sources.

Figure 2.2: The Cook Islands visitor arrivals by country (2010 - 2020)



Source: Ministry of Finance and Economic Management

However, in 2020, border closures in the Cook Islands, New Zealand and Australia as a result of COVID-19, led to a significant decrease in visitor arrivals. New Zealand and Australia accounted for 84 percent of total visitors in 2019. Total visitor arrivals decreased by 85 percent in 2020, to 25,230. The lowest it had been in over 34 years.[6] 98 percent of the 2020 visitor arrivals came in the March quarter, before borders had closed, which reflects how Cook Islands was on track to having another record year for international visitors.

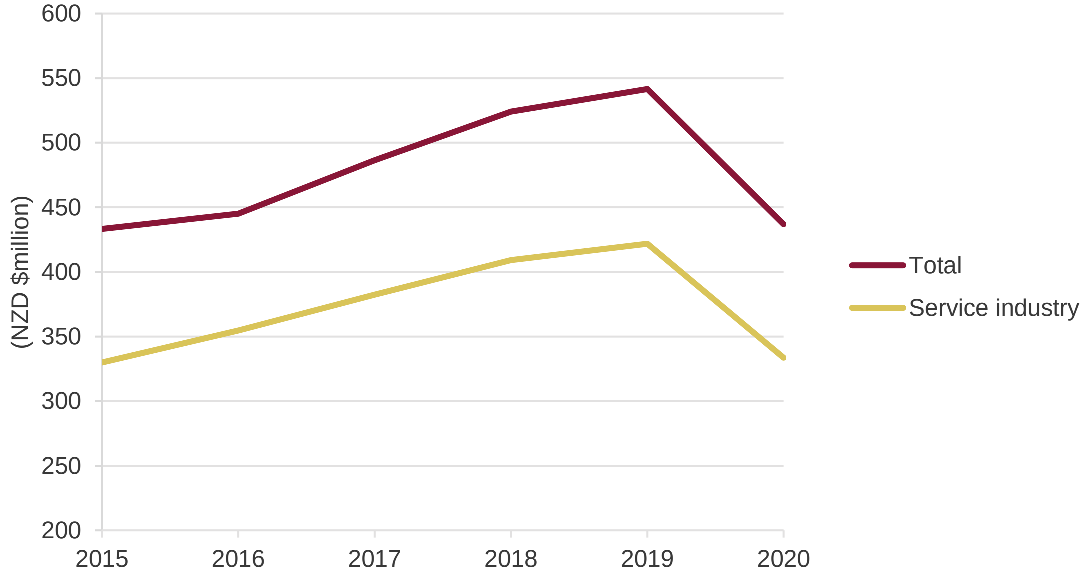
This large reduction in tourists brought the economy to a halt, and led to a substantial decrease in the Cook Islands GDP.

2.2.2 The service industry is the driver of the Cook Islands GDP

GDP in the Cook Islands grew significantly between 2015 and 2019, increasing by 25 percent and reaching a peak of $542 million in 2019, as presented in Figure 2.3.[7] The economy had gone through a five year period of consistent and robust economic growth, with international visitors, and thus the service industry, driving this growth. In 2019, service industry GDP accounted for 78 percent of total GDP in the Cook Islands. The Cook Islands economy was expected to continue growing and was forecast to have another record year, however, due to the global response to COVID-19, the economy suffered greatly.

[6] Ministry of Finance and Economic Management (2021). *Tourism and Migration Statistics.*
[7] Ministry of Finance and Economic Management (2021). *National Accounts*.

Figure 2.3: The Cook Islands GDP (2015 – 2020)



Source: Ministry of Finance and Economic Management

Following a severe drop in international visitors, GDP in the Cook Islands, which is driven by services, dropped significantly. Total Cook Islands GDP decreased to $427 million in 2020, following a major drop in service industry GDP.[8]

In 2019, service industries contributed $422 million (78 percent) to the Cook Islands GDP, but with no international tourism, service industries GDP dropped to $334 million in 2020. The economy was sent into a major contraction as total GDP decreased by 19 percent between 2019 and 2020. This left the Government no choice but to support and boost the domestic economy through extensive fiscal policy.

2.2.3 Government's response to COVID-19

In response to COVID-19, the Cook Islands Government implemented the Economic Response Plan (ERP). The overall objective of the ERP was to support local businesses in the Cook Islands and support the wellbeing of those most impacted. Policies included:

- Wage subsidy
- Cash grants for eligible businesses (up to $15,000)
- Cook Islands National Superannuation Fund (CINSF) contributions reduced to three percent
- Electricity subsidy of 60 percent for all Rarotonga businesses and 100 percent for all Aitutaki businesses
- One-off welfare payment of $400 to eligible beneficiaries
- Employment benefit for all individuals who became unemployed due to COVID-19
- School closure support payment of $100 per child for each fortnight holidays were extended.[9]

[8] Ministry of Finance and Economic Management (2021). *National Accounts*.
[9] Ministry of Finance and Economic Management (2021). *COVID-19 ERP Phase 1, 2 & 3*.

The ERP was funded primarily through borrowing and totalled over 20 percent of the Cook Islands GDP.[10] Across the three stages of the ERP, policies were extended and increased, which provided continued support to the Cook Islands economy as neighbouring nations went in and out of COVID-19 lockdowns. The wide range of policies included in the response was able to limit the contraction of the Cook Islands economy, and helped many businesses and residents.

2.3 Outlook for the Cook Islands economy

Currently, the Cook Islands economy is under a lot of pressure, the Government has borrowed substantially in order to boost and support the economy, but this cannot be sustained in the long term. The future outlook of the Cook Islands economy is solely dependent on borders opening and remaining open.

During the brief three-month period in early 2021, when borders between New Zealand and the Cook Islands opened, the economy was provided with a short-term boost. The Cook Islands was the only travel destination available to New Zealanders at the time, and it seemed on average visitors spent much more than they had spent pre-COVID-19.

There is great optimism that with the borders re-opening early in 2022, a similar boost could occur, and hopefully remain for a much longer period of time. However, with this in mind, there are a few limitations to consider:

- Only double vaccinated individuals can travel to the Cook Islands, which rules out young children. As noted by a stakeholder, families are estimated to be around 40 percent of international visitors
- The opening of borders comes during the middle of the New Zealand summer which may see some people delaying their visit until later in the year
- The Cook Islands will not be the only travel destination available this time. It will now be competing with Australia, the rest of the Pacific and further international destinations.

Although there may be some limitations on the re-opening of the borders, the boost to the Cook Islands economy will still be significant and is much needed. This will be a big step forward as the Cook Islands economy looks to bounce back.

However, partnered with this level of optimism is a certain degree of fear, with the Cook Islands now opening itself up, and potentially exposing the country to a COVID-19 outbreak.

There is also growing concerns that a larger than usual proportion of their population will migrate to New Zealand. Retaining employment in the Cook Islands is already an underlying challenge, and with New Zealand's record low unemployment rate it seems this challenge may become more difficult.

In the short-term, the outlook for the Cook Islands economy remains positive as the re-opening of the borders should provide a much needed boost to service industries, and thus to the entire economy. Assuming borders remain open, the economy will be able to begin its recovery, and will be able to start financing the large Government debt which it has accrued. Similarly, in the long-run, if tourists continue to flow in, there is great optimism that the economy will be in a strong position to bounce back. However, the historic problem of outward migration, and how it may further grow, is still an underlying concern.

[10] Ministry of Finance and Economic Management (2021). *COVID-19 Economic Recovery Roadmap*.

3 The Cook Islands interest rates in comparison to other Pacific nations

The Cook Islands banking sector comprises three commercial banks: ANZ, Bank of South Pacific (BSP) and the Government owned, Bank of the Cook Islands (BCI). For many years, the state of the Cook Islands banking sector has been under scrutiny. In comparison to neighbouring Pacific nations, particularly New Zealand, interest rates in the Cook Islands are much higher. The high cost of borrowing is a burden on the Cook Islands economy, with it leading to higher costs of living and higher costs of doing business.

3.1 Interest rates of the Cook Islands and New Zealand banks

Table 3.1 depicts the interest rates, as of 8 December 2021, for the three commercial banks in the Cook Islands (ANZ, BSP and BCI) and four of the main commercial banks in New Zealand, these being; ANZ, Westpac, ASB and KiwiBank.

Table 3.1: Interest rates of the Cook Islands and New Zealand banks, as at 8 December 2021[11]

Interest rates (%)	Cook Island banks			New Zealand banks			
Lending products	ANZ	BSP	BCI	ANZ	Westpac	ASB	KiwiBank
Personal savings accounts	0.10	0.25		0.10	0.10	0.05	0.10
Term deposit (three months)	1.20	2.60	2.75	0.80	0.70	0.50	0.60
Housing loans	9.00	7.50	8.25	3.65	3.69	3.65	3.69
Business loans	10.00	9.50	7.70	3.10	2.99	1.94	
Personal loans	15.30	10.25	12.50	12.90	13.90	12.90	18.95

Source: Various sources[12]

As shown in Table 3.1, there are very clear differences in the interest rates between banks in the Cook Islands and banks in New Zealand. The Cook Islands interest rates are notably higher than New Zealand rates, with a number of factors driving this difference, as is explained in section five. Recently, the rates between the two nations have trended towards each other, with New Zealand rates increasing slightly and the Cook Islands rates decreasing slightly. New Zealand rates are trending upwards, after the official cash rate (OCR) was increased for the second consecutive review, and is forecast to continue increasing.

The observed margin (i.e. lending rate less term deposits) for housing loans is between 4.9 and 7.8 percent, and between 4.9 and 8.8 percent for business loans. The nominal interest spread, the difference between the cost of deposits and the lending rate, for New Zealand and the Cook Islands, is around three percent for home loans and five percent for business loans.

In November, BSP reduced their term deposit rate from three percent to 2.6 percent and their housing loan rate from 8.25 percent to 7.5 percent.[13] However, New Zealand banks have had to shift their rates up slightly, with the on-going increase of the OCR and growing concern in the economy.

For housing loans in New Zealand, the four commercial banks highlighted, charge interest of around 3.65 percent, which is well under what the banks in the Cook Islands require, with rates varying

[11] If no rate is provided, then this product is either not provided by the bank or the rate is not publicly available.
[12] See Appendix A for data sources.
[13] Bank of South Pacific (2021). *Account Interest Rate review.*

between 7.5 percent and nine percent. Additionally, business loan rates in the Cook Islands are almost triple that of the business loan rates offered by New Zealand banks. New Zealand is very clearly a much more appealing lending environment in comparison to the Cook Islands, however, it operates in a very different economy.

3.1.1 Real interest rates

Real interest rates are interest rates that have been adjusted to remove the impact of inflation and are useful for household and business decisions. After averaging interest rates across the banks in each country, and then adjusting for inflation (consumer price index) in each country, we get an estimate of real interest rates in the Cook Islands and New Zealand.

The distinct difference in interest rates, highlighted in Section 3.1, remains when comparing real interest rates between the Cook Islands and New Zealand. After adjusting for inflation, the average real home loan rate in the Cook Islands was 7.55 percent in 2021, compared to 2.17 percent in New Zealand.

This is mainly a result of inflation in the Cook Islands economy historically being lower than inflation in New Zealand. However, it is important to note that this analysis does not capture the recent and more extreme increases in New Zealand's inflation. If these recent increases in New Zealand's inflation were captured, the difference in real interest rates would be much narrower.

3.2 Financial soundness indicators

Financial soundness indicators (FSI) are used to measure the financial health and soundness of the financial institutions in a country. Table 3.2 presents five FSIs for five nations; the Cook Islands, New Zealand, Fiji, Samoa and Tonga. FSIs have been used to paint a comparable picture of the differences between the financial sectors of different Pacific nations.

Table 3.2: Financial soundness indicators, 2018

Financial soundness indicators, 2018 (%)	Non-performing loans to total gross loans	Return on assets	Return on equity	Liquid assets to total assets	Liquid assets to short-term liabilities
Cook Islands	4.04	0.95	15.16	50.79	95.81
New Zealand	0.50	1.00	13.00	13.30	19.80
Fiji	3.09	2.78	24.12	15.10	61.61
Samoa	3.60	3.90	23.90	16.30	33.40
Tonga	3.60	3.20	16.00	27.10	51.00

Source: Various sources[14]

Non-performing loans to total gross loans

A non-performing loans to total gross loans ratio indicates the quality of banks' credit portfolios, with a higher ratio representing a worse quality portfolio. In 2018, the Cook Islands financial sector had a non-performing loans to total gross loans ratio of four percent, which was the highest of the five nations and sat well above New Zealand's ratio of 0.5 percent, as depicted in Table 3.2.

[14] See Appendix A.

This suggests the quality of the credit portfolios of the Cook Islands banks is not as good as most other Pacific nations and much worse than New Zealand's in 2018. However, banks in the Cook Islands have improved the quality of their credit portfolios, by reducing bad debt, and this is reflected in a decrease in their ratio from 6.8 percent in 2014 to four percent in 2018.

Return on assets and equity

In 2018, the Cook Islands financial sector had a return on assets ratio of one percent, which was the lowest of the five nations listed in Table 3.2. This low return on assets indicates low economies of scale that affect the profitability of the Cook Islands banks.

This ratio reflects the efficiency of banks to manage their assets in order to generate earnings, and therefore, means financial institutions in the Cook Islands are not able to generate earnings through their assets at the same level as other Pacific nations. This partly reflects the limited market for lending which exists in the Cook Islands.

A return on equity ratio shows the ability of banks to internally generate capital through retained earnings and, in 2018, the Cook Islands financial sector had a return on equity ratio of 15 percent. A ratio of 15 percent, places the Cook Islands equity ratio at a similar level to Tonga and slightly greater than New Zealand, but below Fiji and Samoa.

Liquidity measures

In 2018, the Cook Islands financial institutions had a liquid assets to total assets ratio of 51 percent, which was almost double every other Pacific nation's ratio, as shown in Table 3.2. Additionally, the Cook Islands liquid assets to short-term liabilities ratio was 96 percent in 2018, which was notably above other Pacific nations. These two ratios reflect the level of liquidity available to meet expected and unexpected cash flows, and short-term withdrawal of funds. The Cook Islands economy is highly liquid, and much more liquid than other Pacific nations.

As expanded on later in the report, following the strong performance in the Cook Islands economy, there was a very high level of domestic deposits (savings) in the economy. In 2020, it was estimated the level of domestic deposits was around $400 million, and domestic lending was only $272 million. This indicates that the money is there for lending, however, opportunities are limited. This leads to banks in the Cook Islands holding onto proportionately much larger amounts of liquid assets in comparison to other Pacific nations.

4 Banking in the Cook Islands

The Cook Islands banking environment has changed slightly since Sam Knowles' 2012 report.[15] Driven by the banks themselves, and the strength of a growing tourism market, the level of deposits has increased while the proportion of non-performing loans has decreased. This section provides an overview of the banks currently operating in the Cook Islands, followed by a summary of the two areas of concern highlighted in the 2012 report (non-performing loans and scale), and also an assessment of the concerns and current position in 2021. Finally, this section concludes with a summary assessment of interviews that we conducted with Cook Islands residents and businesses with access to banking in New Zealand.

4.1 Banks operating in the Cook Islands

In 2012, there were three banks operating in the Cook Islands.[16] Two of these were subsidiaries of Australian Banks, ANZ and Westpac, and the third is the Cook Islands Government owned Bank of the Cook Islands (BCI). At that time, ANZ had 45 percent market share, Westpac 40 percent and BCI 15 percent.[17]

In 2015, Westpac sold its banking operations in the Cook Islands, Samoa and Tonga to the Bank of South Pacific Limited (BSP) for AU$91m, including five branches in the Cook Islands.[18]

The three banks continue to operate and the banking sector remains small. The relative size of the three banks would make them the equivalent of a tier two finance company in New Zealand.

The lending market is now dominated by BCI which has 41.5 percent of all lending, BSP has a 35.9 percent market share, while ANZ has the smallest market share, accounting for the remaining 22.6 percent.

4.1.1 ANZ

ANZ is a multinational bank headquartered in Melbourne, Australia and has been operating a subsidiary in the Cook Islands since 1988. It is the only bank in the country with a global presence. ANZ offer the largest range of commercial services and has the highest credit rating of the three banks. ANZ currently has 36 staff in the Cook Islands.

ANZ maintains the most rigorous lending practices of the three banks. This was supported by residents who identified ANZ as the most conservative of the banks. Amongst Cook Islanders we spoke with, it was common for them to mention that ANZ cleaned up bad debts, cut down lending and were no longer making the same loans they would have made previously.

Since the 2012 report ANZ has shrunk its presence in the personal and home loan markets. ANZ has approximately 35 percent of commercial loans, 18 percent of retail loans, and less than two percent of personal loans.

The experience of the global financial crisis, and the high level of non-performing loans that came about as a result, has shaped the focus of ANZ's commercial lending. This has seen it solidify its commercial portfolio with a focus on providing competitive rates to clients that have the greatest

[15] Knowles S. (2012). *Cook Islands Banking Review. July 2012.*

[16] Capital Securities Bank (CSB) is located in Cook Islands but does not operate domestically. CSB clientele are exclusively from the offshore financial services industry.

[17] Knowles S. (2012). *Cook Islands Banking Review. July 2012.* Page 9.

[18] Westpac (2015). *Westpac completes sale of its operations in three Pacific Island nations.*

ability to repay. Interviewees affirmed this, noting that ANZ were focussed on the high value, low risk customers with strong reputations.

As an international bank, ANZ benefits from economies of scale and is able to spread the cost of its group expenses across its vast international network. This network allows ANZ in the Cook Islands to offer its customers many of the same services that are available to customers in New Zealand and Australia.

Some interviewees were of the opinion that having ANZ in the Cook Islands is good for the reputation of the country and its financial sector.

4.1.2 Bank of South Pacific

As noted above, in 2015, Westpac sold its banking operations in the Cook Islands to BSP Financial Group Limited. BSP Financial Group's operations date back to 1957, when it was founded in Port Moresby as a branch of National Australia Bank. In 1993, a consortium of Papua New Guinea (PNG) businesses acquired the bank and created the first and only PNG private sector owned bank at that time. BSP merged with the state-owned Papua New Guinea Banking Corporation in 2002, creating the largest bank in PNG by market share. Other acquisitions followed, including the purchase of Westpac's South Pacific businesses (excluding PNG and Fiji).

Today, BSP Financial Group has the largest branch and electronic networks in the South Pacific. Further, with the exception of Vanuatu and the Cook Islands, BSP Financial Group is the largest lender in all of its markets.

BSP Cook Islands (BSP) has two branches and 14 ATMs across the Cook Islands, and employs 60 staff with the majority in customer facing roles.

BSP's loan mix is approximately 40 percent commercial loans and 60 percent retail loans. Approximately 85 to 90 percent of retail loans were for mortgages or investment purpose, while the remaining 15 percent were personal loans. Furthermore, BSP has a 55 percent share of deposits.

BSP occupies the middle ground in the Cook Islands market. BSP provides retail and corporate banking services in all of its markets, including the Cook Islands. Similar to other large banks operating in the Cook Islands, BSP has the ability to spread its product development, branding, technology and other support services costs across its geographies, given the scale of its South Pacific operations.

4.1.3 Bank of the Cook Islands

Bank of the Cook Islands (BCI) is a 100 percent state owned commercial bank. BCI plays an important role in the Cook Islands banking system as it operates exclusively in the Cook Islands and is the only bank that has branch presence in the majority of the inhabited outer islands. BCI also fills the role of distributing and managing the child benefit and elderly pension on behalf of the Government, as well as administering the Motor Vehicle registry database. BCI currently has 93 staff filling 81 full time equivalent positions. BCI has a ten site branch network which employs one or two staff for 20 to 35 hours per week.

BCI has strength in the home loan market, with a sizeable market share. However, it has the smallest share of commercial customers. This is in part due to capital exposure limits imposed by the Banking Act. A previous report identified two reasons why BCI struggles to attract commercial customers. Firstly, BCI lacks international coverage, and diversity of services. Secondly, BCI faces high overheads and a lack of scale, limiting its ability to spread costs.[19] As in the market itself, BCI faces challenges with low margins, scale, and the expectations of shareholders and stakeholders which include delivering financial services that empower customers, promote social responsibility and environmental stewardship, and also produce sound financial returns.

BCI's issues of scale flow through to its operational and pricing challenges. BCI is aggressive with its lending and deposit rates and operates with the smallest margins of the three banks. The lack of scale means BCI must greatly diversify its revenue base to reduce costs, and drop its rates to put any pressure on the other banks to lower interest rates. Advances in technology may put BCI at a further disadvantage when it comes to costs as BSP and ANZ can spread their costs across their international networks, and thus lower their business costs.

4.2 The Cook Islands banking in 2012

The purpose of the Knowles 2012 review was to identify how banking could more effectively contribute to achieving higher economic growth. The objective was to 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 accessibility to banking by Cook Islands businesses and residents
- Provide banking services necessary to support the major growth sectors of the economy
- Minimise the need for Government financial support to achieve the above.

In 2012, the key issues for the banking industry were:

- The lengthy, complex and expensive process of getting to the situation where banks can put mortgage security (i.e. property leases) up for sale
- The lack of buyers for property leases in a market restricted to residents and approved businesses applicants
- The lack of enforceability of personal lending contracts with no statutory bankruptcy provisions, or court order enforcement capability
- Few new business opportunities, and competition for existing business limited by the high cost and complexity of transferring or increasing a mortgage on a lease.[20]

Despite these challenges, the banking system in the Cook Islands appeared to be relatively competitive, with businesses providing anecdotal examples of rate competition and negotiated reductions. Competition was keeping profit levels below organisational targets, while loan rates were below where the high cost, and risk, of lending implied they should be.

The Knowles 2012 review highlighted two specific problems the Cook Islands banks faced in lowering the cost of banking and making it easier for business and residents to access affordable lending: non-performing loans and scale.

4.2.1 Non-performing loans

The Knowles 2012 review was prepared in the wake of the global recession that began in 2007. Incomes had dropped significantly, leaving many borrowers struggling to meet repayment

[19] Okotai, P. (2020). *The Costs of Borrowing*. Page 23

[20] Knowles S. (2012). *Cook Islands Banking Review. July 2012.* Page 10.

obligations. This led to a major overhang of non-performing debt and attendant securities (mortgages) which banks were struggling to clear in a market that had very low sales levels for homes and businesses.

In 2012, non-performing loans sat at $45 million. This was around 16 percent of all loans, with the corresponding number in New Zealand being one percent.

Non-performing loans presented challenges for the Cook Islands economy. These loans were estimated to cover $60 million of leases that banks were trying to sell through mortgagee sales, in a market where annual sales were 10-12 properties per year. The implications of these non-performing loans were expected to include:

- Continued reduction in property values, and limited new construction activity due to the overhang of existing property for sale lower than replacement costs, reducing the amounts banks were prepared to lend
- Low bank profitability for a number of years necessitating money being set aside to cover expected capital losses of 35 percent of non-performing loans
- Lending rates increasing, due to banks carrying the non-performing loans and the increase in lending risk
- Reduction of access to credit with Australian banks making lending decisions outside of the Cook Islands using conservative loan to value criteria.

Non-performing loans since 2012

The high level of non-performing loans in 2012 was a hangover from the global financial crisis. Before the crisis the Cook Islands economy was performing strongly, tourist numbers were increasing and loan books were growing.

In the decade since, as the Cook Islands recovered, strong economic growth and a tightening of lending practices by banks, meant that this issue of non-performing loans was reduced to under five percent, which is believed to be a sustainable level.

Prior to COVID-19, the FSC estimated that 3.7 percent of loans were non-performing. However, the proportion of non-performing loans is expected to increase to between five to seven percent as the Cook Islands struggles with the impacts of COVID-19.

4.2.2 Scale

In 2012, banking in the Cook Islands was very low scale compared with New Zealand and other large Pacific Islands countries, for example Samoa, Tonga, and Fiji. The Cook Islands population in 2012 was the equivalent of a town like Rangiora or Levin. The Knowles 2012 review estimated that based on population ratios, the industry should employ 60-70 people, rather than the 210 the industry did employ. The scale concern was even more pronounced due to the fact that services offered in the Cook Islands were limited, and many businesses were doing a proportion of their banking in New Zealand.

Scale since 2012

Issues of scale have continued to keep the Cook Islands lending rates higher than those in New Zealand. The inherent cost of remoteness and a small population is not something that can be easily influenced by the Cook Islands Government, or the banks. Banks continue to carry a relatively high number of staff per customer with one branch per bank having to provide the entire suite of services to a limited market of less than 10,000 customers and about 1,000 businesses.[21]

Total employment across the three banks is 189 staff, and while this is a decrease from 210, it remains above the 60-70 that were estimated to be required to serve an equivalent population in New Zealand. Duplication of resources across the three banks adds to the costs. Approximately 40 percent of staff across all banks are in back office roles. BCI is the bank with the greatest number of branches. Its 93 employees provide an indication of the number of staff required to serve a community the size of the Cook Islands.

The overwhelming view amongst interviewees in 2021 was that the Cook Islands is well served by the three banks, but the islands are overbanked for the number of people they serve. This makes the cost of banking, and lending, higher than necessary.

4.3 Cook Islanders banking in New Zealand

We were unable to access data on the number of Cook Islanders with access to a New Zealand bank account. However, the majority of interviewees were of the opinion that almost all Cook Islanders, who at some point in their life have lived in New Zealand, would have access to a New Zealand bank account. Due to the free association relationship between the Cook Islands and New Zealand, large numbers of Cook Islanders have lived, or currently live, in New Zealand for education, employment, or family reasons. During their time in New Zealand they are likely to have opened a New Zealand bank account. Of those who have returned to the Cook Islands, the majority are thought to have kept these accounts active.

A significant proportion of Cook Islands businesses, predominantly service industry businesses and/or business which have suppliers or customers from New Zealand, will have access to a New Zealand bank account. Having access to a New Zealand bank account is a benefit for these businesses. The majority of visitors to the Cook Islands are from New Zealand and having New Zealand accounts is an easy and efficient way to receive payments from New Zealand customers, and make payments to New Zealand suppliers. Payments made between New Zealand and the Cook Islands incur a fee which is charged on each transfer. For a long time this fee has been $25 and many interviewees did not understand why the fee is required, given that the transactions are in the same currency. The banks confirmed they are taking actions to reduce this charge.

Common practice is still for businesses to make transfers to and from the Cook Islands in a lump sum to avoid incurring the cost of multiple transfers.

A very small proportion of Cook Islanders would be in a position where they hold high-value assets in New Zealand, for example property, which they could use as security to lend against with New Zealand banks. Of those who do, borrowing through New Zealand banks would always be their first choice to avoid the higher interest rates in the Cook Islands.

Interviewees told us that in their experience most foreign investors considering the Cook Islands will fund investments using assets held elsewhere. Due to the high cost of borrowing, the Cook Islands banks are used as a last resort.

[21] Okotai, P. (2020). *The Costs of Borrowing.* Page 13.

5 Drivers of interest rate differences

The Costs of Borrowing (the Costs of Borrowing report)[22] breaks down the cost of borrowing into a simple formula.[23]

Cost of borrowing = Cost of business + profit margin

The cost of business can be broken down into two primary components, the **cost of operations** and the **cost of risk**.

This section addresses the drivers of high interest rates in the Cook Islands in 2012, summarises the cost of risk and the cost of operations factors identified in 2020, and assesses the potential to influence these drivers to reduce the cost of borrowing in the Cook Islands.

5.1 Drivers identified in 2012

In 2012, Cook Islands businesses expressed concern that the cost of business finance was too high, particularly compared with what was charged in New Zealand, which uses the same currency. One of the concerns was that the observed margin for mortgage secured finance was over seven percent (i.e. term deposits at three percent and loans from 10.5 percent) compared with a two percent margin in New Zealand.

Knowles identified that “nominal interest spread difference between the cost of deposits and the lending rate for New Zealand and the Cook Islands is around five percent.”[24]

This was driven by three areas of additional cost:

- Risk cost (cost of risk)
- Offshore funding (cost of operations)
- Scale (cost of operations)

The three banks were unable to provide a breakdown of the impact of these drivers in 2020. Offshore funding has disappeared and been replaced by domestic funding, while issues with scale remain, and are difficult to overcome. The risk cost appears to have not changed much since 2012, although the reduction in non-performing loans, and better lending practices, should have reduced the risk of lending.

5.2 Cost factors identified in 2020

The 2020 Costs of Borrowing report breaks down the costs of borrowing into cost factors, split by the cost of risk and the cost of operations. Of the 2012 drivers, non-performing loans and risk cost are contained in the cost of risk factors, while scale is included in the cost of operations. The report rated the impact on borrowing costs as significant, high, or minimal.

The Costs of Borrowing report estimated that the average interest rate (loans and advances plus loan and fee charges) was 9.3 percent. The report estimated that the cost of funds for the banking sector accounted for over a third (3.4 percent) of the rate, resulting in a net margin of 5.9 percent. This net margin includes the cost of risk, as well as operating expenses, and overheads.[25] The report

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[22] Okotai, P. (2020). *The Costs of Borrowing.*
[23] Okotai, P. (2020). *The Costs of Borrowing.* Page 11.
[24] Knowles S. (2012). *Cook Islands Banking Review. July 2012.* Page 11.
[25] Okotai, P. (2020). *The Costs of Borrowing.* Page 15.

also noted that the banks will dispute this and argue that their net interest margin is between two and 3.5 percent.

Market forces, and the fact that there haven't been any new banks expressing interest in breaking into the market, would indicate that the banks have correctly assessed the risk profile, including operational costs around size and efficiency.

5.2.1 Cost of risk

Following the global financial crisis, the Cook Islands banks tightened their monitoring of risk. The 2012 Knowles review noted that "[the banks] potentially see much lower value from the underlying mortgage securities for loans".[26] This has increased the demands on borrowers for financial information and loan compliance.

In 2012 risk cost was adding two to three percent to rates, due to the cost of funding, managing non-performing loans, and provisions for write-offs. This cost was the main reason that rates did not come down in parallel with Australia and New Zealand. This cost was expected to increase unless some of the underlying issues inhibiting the sale of mortgage leases supporting non-performing loans were addressed.

The factors that influence the cost of risk do not appear to have greatly changed since 2012. Although the economy has performed strongly and the number of non-performing loans and mortgagee sales has fallen, the perceived risk of lending in the Cook Islands remains relatively unchanged.[27] Complexities of land tenure and the risks of default remain a concern for lenders.

It has been suggested that because there has been a decrease in defaults, there should have been a decrease in the risk cost built into lending rates. However, just because the Cook Islands economy has performed strongly, it does not mean the risk is any less. COVID-19 has highlighted how quickly things can change. The banks will maintain a conservative outlook on the back of previous economic shocks. Also, without Government support during COVID-19, default rates would have increased significantly. Although practices have tightened the perception of risk remains.

The cost of risk has five components; non-performing loans, land tenure, sovereign risk, compliance costs, and other local risks. The impact of these factors on borrowing costs ranges from significant to high.

Non-performing loans

Impact on borrowing costs: High

Although the proportion of non-performing loans has reduced, it remains above the proportion in New Zealand. The number of non-performing loans is likely to increase given the impact COVID-19 has had on the Cook Islands economy. However, there is limited potential for Government intervention. The Costs of Borrowing report identified borrowing limits as a solution that has worked elsewhere to deter development bubbles in the real estate market.

The report noted there was scepticism that the number of non-performing loans could be decreased further without a significant negative impact on banking, and a reduction in total borrowing.[28]

[26] Knowles S. (2012). *Cook Islands Banking Review*. July 2012. Page 8.
[27] ANZ has not made a mortgagee sale since at least 2015. However, it has written off bad debt during this period.
[28] Okotai, P. (2020). *The Costs of Borrowing*. Page 11.

As noted above, non-performing loans and the difficulties banks have recovering lost funds from non-performing loans, continues to remain a concern for banks as they price their perceived risk.

Land tenure

Impact on borrowing costs: High

Despite the recommendations made in 2012, the Costs of Borrowing report identified land tenure as "the biggest factor difference between the New Zealand and the Cook Islands operating environment, where laws make recovery of forfeiture difficult, slow, and expensive."[29]

As identified earlier there is little appetite within Government for intervention, and there are unlikely to be any fundamental reforms in the near future. However, the Costs of Borrowing report notes that "incremental changes to the legislation could assist".[30] More information on potential changes is addressed in section 6.1.2.

Land tenure presents the greatest risk for risk averse banks. Most freehold land in the Cook Islands is protected by law and can only be owned by Cook Islands families. When a parent, who is a landowner, dies, their child or children are entitled to succeed to the parent's interest in their land.

A leasehold interest is one of the most common forms of land ownership in the Cook Islands. Leases allow the underlying freehold title to be owned by dozens or even hundreds of family landowners. Individuals and business who are not landowners, can own a leasehold interest in someone else's land. Leases can be for a maximum of 60 years. However they can be renewed at any time. Interviewees noted that it is rare for a lease not to be renewed. Most commercial lease holders start to negotiate when there are 25 years remaining on a lease.

In the absence of freehold title as security, leases are security for banks. Banks will not lend without security and a lease is the most valuable asset many own.

Land tenure and the lease system are often not a problem until something goes wrong. However, the perceived risk remains for the banks. An interviewee noted that in their experience approximately 60 percent of lease sales have no trouble, 35 percent have minor difficulties and five percent face significant difficulties.

The risk cost of the land tenure system comprises four components. The first is the lack of certainty of title, the second is the diminishing value of the security, the third is the small market for re-sale of a lease, and the fourth is the time and cost of selling a lease.

Deeds title system

There is a lack of certainty of title due to the deeds system that is priced into the cost of risk. Banks do not have the same guarantees that they have with the Torrens system in New Zealand. If an interest in land has not been properly identified and consulted, the lease can be challenged and ultimately voided, rendering the banks security worthless. With the possibility of over 1,000 land owners this can become difficult.

The banks have had some unfavourable court decisions that reinforced the view of this risk. Multiple hearings can add years to the process. However, this risk is mitigated by banks using lawyers with professional indemnity insurance to conduct due diligence on potential landowners.

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[29] Okotai, P. (2020). *The Costs of Borrowing.* Page 11.
[30] Okotai, P. (2020). *The Costs of Borrowing.* Page 11.

Diminishing value of leases

The nature of leases is that the value of the lease diminishes as time passes, reducing the value of the security held. This reduces the possible value that can be recovered by the banks, and to account for this diminishing value it is incorporated into lending rates.

A counter argument was made by one interviewee who identified that if a lease is for 60 years most lending periods were for a maximum of 30 years, meaning the loan should be repaid with half the lease remaining. Assuming the lease holder makes re-payments before defaulting on a loan, the value of repayments made should offset the diminishing value of the lease.

Small market for re-sale of leases

Business leases are more marketable than residential leases as investment in business is often the only way non-Cook Islanders can reside in the Cook Islands. Only Cook Islanders (descendants, or those with permanent residency status) or those already operating in the Cook Islands, can purchase a lease for a vacant residential section, residential land, and residential property in the Cook Islands. However, it is legally possible to reside in the Cook Islands by:

- Purchasing an existing commercial property or business that is listed for sale
- Establishing a new business in a joint venture partnership with a Cook Islander, where the Cook Islander is a majority shareholder
- Establishing a new business in an activity where there is demonstrable demand for the activity, and no Cook Islander is currently carrying out that activity
- Establishing a new business with a minimum investment of $1 million on Rarotonga and $500,000 on Aitutaki
- Developing a niche market or niche product.

The restrictions for residential property limit the market for property leases and restrict the value that can be recovered from a mortgagee sale, and is included in interest rates. The pool of potential buyers gets smaller as Cook Islanders can avoid buying a lease and access their traditional family land at much lower cost.

There is no incentive to buy a lease when local people can access traditional family land. Land owners can obtain a lease from their family and then borrow for the materials and labour required to build a house on that land.

Local real estate agents estimated that 30 percent of buyers are international and 70 percent are local. Cook Islanders commonly purchase properties under $600,000 and use the Cook Islands banks.

Time to sell a lease

The time to sell a lease, and the costs associated with selling a lease, are priced into the cost of risk in lending rates. The average age of defaulted loans when they are cleared is three to five years. If you can get in and out in 18 months you are doing well. Meanwhile, in New Zealand these can be cleared almost immediately.

Land holder consent slows down the process. Before a lease can be sold the banks must offer first right of refusal to the land owner, which slows the process. Interviewees spoke of experiences where land owners hold back until an offer is made and then react. If a land owner does not take up the right of refusal then the agreement of the land owners is required before a lease can transfer to a new owner.

The requirement for owner approval depends on when the lease was taken out and the specific terms of the lease agreement. Some agreements, mostly older, require 50 percent of all land owners to agree, while others just require half of those living on the relevant island. This can become a time consuming and costly process, especially if a majority of all those with an interest is required.

The banks also face costs to clear any outstanding lease debt owed to the land owner. The banks are required to clear outstanding debts before the lease can be sold. In some cases this can be as high as $80,000.

Sovereign risk

Impact on borrowing costs: High

The Cook Islands Government credit rating is the ceiling for the credit rating for the country. It is influenced by the amounts of debt held nationally and by the Government, as well as the country's economic growth prospects. The better a country's overall debt position and future economic potential is, the lower the risk. At the time of the Costs of Borrowing report, the Cook Islands Government had a credit rating of B/B+, compared to an AA rating for New Zealand. The higher the sovereign risk the higher the cost of borrowing.

The potential for the Government to influence sovereign risk is high. Given the increased borrowing to support the country through COVID-19, any improvement to the Government's credit rating is unlikely in the short term. In fact it is likely to deteriorate. However, in the medium to long term if the Government can control spending and reduce Government debt, there is the potential to improve its credit rating and bring down the cost of borrowing.

There was concern expressed by interviewees that the Cook Islands debt to GDP ratio had increased due to the COVID-19 spending. There was a fear that this level of debt to GDP would be unsustainable for a small island nation and that this would be passed onto future generations. Interviewees identified a swift return of tourism as the way to combat this in the short-term, while longer term initiatives to grow GDP and revenue are investigated.

Compliance costs

Impact on borrowing costs: Significant

These are the costs of meeting regulatory demands. They are often related to money laundering and tax avoidance. For BSP and ANZ this includes the regulatory demands of their home markets, and the other markets they operate in. This is an advantage for BCI as it only operates in the Cook Islands.

As compliance costs increase internationally, the Cook Islands banks need to meet these requirements in order to operate in the international financial system. The limited customer base means that these costs are higher per customer in the Cook Islands.

There is minimal opportunity for Government to influence this cost outside of its domestic compliance requirements.

Concern was raised by some interviewees about the potential for the Financial Supervisory Commission (FSC) to introduce more "red tape".

Other local risks

Impact on borrowing costs: Significant

The risks associated with the local Cook Islands market is costed into interest rates and captures other variables including challenges unique to doing business in the Cook Islands.

Small close knit community

The banks are aware that in such a small community, it risks reputational damage if a bank forces a family out of their home or business. Concerns of negative publicity mean that banks are willing to spend time working with customers to facilitate repayments. This comes at a cost to the banks, which is included in the cost of risk.

Tourism dependence

The high dependency on one industry, tourism, also contributes to increased perceived risk and is priced into interest rates. The Cook Islands dependence on tourism makes the perceived risk of the market greater than in a more diversified economy, for example New Zealand. ANZ takes a portfolio approach to its lending and takes concentration in the tourism sector seriously. There were concerns amongst interviewees about the concentration of lending linked to the tourism sector and the associated risk.

As identified in the recommendations in the Costs of Borrowing report, which is discussed later, diversifying the economy is one opportunity to reduce the consolidation risk. However, tourism has historically been profitable and more attractive than other industries.

Relocating to New Zealand and Australia

Another risk unique to the Cook Islands market is that people can easily leave for New Zealand or Australia, leaving loans behind. Although the asset remains as collateral for the lender, the value recoverable is likely to have diminished. An example provided by an interviewee was of an individual who had taken out a loan for a vehicle, then a few days later sold it, and left for New Zealand with the money. Although it negatively impacts a person's credit rating in the Cook Islands, enforcing repayment from abroad is difficult.

Financial understanding and preparedness

Financial education is also an area of concern for the Cook Islands and adds to the market risk of lending. Depending on personal circumstances, as in New Zealand, some people have no option and have to get a loan. They will keep shopping around until they get one, and the interest rate is often not a consideration. In some cases there is a lack of understanding of the details on how the loan will be paid back and the consequences of non-payment. While in other cases, interviewees noted that borrowers know loans need to be paid back, but are aware that the banks might be reluctant to pressure them to make repayments for fear of reputational damage.

Interviewees also commented that on a corporate level, adequate corporate governance is lacking, particularly for smaller businesses. Businesses that have improved corporate governance and operating practices have been able to access lower costs of borrowing.

5.2.2 Cost of operations

The cost of operations is dominated by the impact of lack of scale. The situation of three stand-alone banks operating in a market the size of a New Zealand town, with a world class supervision and compliance regime, and high input costs, is extremely low scale. In 2012, it was estimated that at least two percent of the extra spread was attributable to this, on the basis that costs are more than twice what they would be in a scaled market.[31]

The cost of operations has three major factors; staff and overheads, competition, and the base cost of credit. The impact on borrowing costs ranges from significant to high.

Staff and overhead costs

Impact on borrowing costs: Significant

As addressed earlier, the lack of scale continues to keep the Cook Islands lending rates higher than those in New Zealand. All three banks identified a lack of scale as a major driver of the differences in rates between the Cook Islands and New Zealand.

The inherent cost of remoteness and a small population is not something that can be easily overcome by the Cook Islands Government or the banks. The relatively small population of the Cook Islands limits the number of potential customers across which costs of staff and other overheads can be spread. The main way banks recover these costs is through interest rates.

The banks noted that their ability to generate revenue in other ways is limited. The small size of the market limits the potential revenue that can be gained from account fees. This necessitates higher charges in other areas to make up for this inability to spread fixed costs. Since they use the New Zealand dollar, and the majority of tourists are from New Zealand, the banks do not have access to the same foreign exchange revenue streams that are available in New Zealand.

Technology

Technology has become an important part of the banking industry. The internet has changed the way banks operate and interact with customers, putting more services online. Across the world this has reduced the cost of banking and reduced the number of employees required to carry out banking activities. Technology comes with a positive and negative impact on banks' costs. While it lowers the cost of interacting with clients and other operational areas, there is an upfront cost required as well as ongoing maintenance and development.

Technology and systems used by the Cook Islands banks are still lagging behind those used in New Zealand. For example, a basic spreadsheet-based system is in place to enable the daily clearing of transactions. However, technology improvements require upfront capital investment and ongoing operational costs to maintain systems and processes. The Costs of Borrowing report notes that "a more robust system may automate these payments domestically, but again it's questionable whether the benefits will outweigh the costs."[32]

While technology hasn't decreased costs for banks just yet, further improvements will. BSP is looking to technology to reduce costs and improve its digital offering. Consequently, BSP is replacing its existing core banking system in all jurisdictions. BSP went live with an Oracle solution in Vanuatu in April 2021, The new Oracle system will be rolled out progressively throughout the BSP Network in coming years.

The Cook Islands economy is still very cash based and the uptake of technology in banking could take time. Many Cook Islanders still want a physical banking presence and many still rely on face

[31] Knowles S. (2012). *Cook Islands Banking Review. July 2012*. Page 11.
[32] Okotai, P. (2020). *The Costs of Borrowing*. Page 8.

to face banking, particularly the older population. BCI is mindful of maintaining representation on the outer islands.

As younger customer segments are key adopters of digital and online banking solutions, the Cook Island's growth outlook appears promising. Noting that the Cook Island's has high cell phone penetration and digital banking transactions are increasing. BSP reports that transactions completed through technology, including electronic funds transfer at point of sale (EFTPOS), continue to increase and that this was a more cost effective and efficient payment method than cheques, which are still popular in the Cook Islands.

Promoting technology and telecommunications, particularly on the outer islands, is seen as critical to lowering the costs of banking. The level of service available will determine what banks can offer. The Cook Islands Government has some influence here. The Manatua cable has already seen the price for telecoms reduce. Competition and regulation in the telecoms market should reduce these costs to allow more use of online products and services which could reduce bank operating costs.

Competition

Impact on borrowing costs: Significant

Competition is a major determinant of interest rates and the three banks have very different strategies. These strategies see each bank target different parts of the market. Stakeholders commented that the primary focus for ANZ appears to be commercial lending, with a strong focus on providing competitive rates to high value, low risk customers. Meanwhile, BCI dominates the home loan market and has been increasing its market share. However, BCI struggles to attract commercial customers. BSP occupies the middle ground in the market.

The banks were of the opinion that there was competition in the market, but the majority of non-bank interviewees did not agree with this assessment. The view of the majority of non-bank interviewees was that rates are higher than they should be because of the lack of competition. The common view amongst interviewees was that the banks compete for business on the fringes. The banks have found, and settled into, their positions in the market. Opinions were expressed that there was consensus between the banks on what they can and cannot charge, and to whom.

Interviewees estimated that the banks really only compete for 20 percent of the market. ANZ is considered difficult regarding who they will lend to, and have what were described as "onerous processes" that require significant reports. This has deterred some borrowers as smaller businesses are not able to meet the requirements.

Some interviewees said that ANZ advertise high rates but offer lower rates to high value clients. BSP are competing on rates to attract customers away from ANZ. When discounts from advertised rates are considered, BCI is seen as a price taker which picks up what the others do not want.

BCI has historically led the way with rate decreases and is seen as keeping the others honest.[33] Interviewees were concerned that without BCI, the other two banks would charge higher rates. BCI does not have the resources, or international networks, to compete with ANZ and BSP to attract larger clients through price competition.

Another complaint from interviewees was that banks demand out of context security for the loans that are being made. Examples provided include one bank wanting security over an asset 20 times the size of a loan, and requiring guarantees from non-resident holding companies.

[33] In the latest round of home loan base rate reductions BSP moved to 7.5 percent and were then followed by ANZ which reduced its rate to 7.25 percent. This was then matched by BCI.

The Costs of Borrowing report looked at creating a second state owned bank but found that it would be inefficient, considering that BCI is already state owned, and there would be significant capital and operational costs. The report identified that the source of finance could not come from depositors and suggested that if a new bank was to be created it would be best to focus on the development of new sectors of the economy.[34] The report identified the opportunity for the Government to invest its own funds, or on-lending conditional financing, to fund development.

There are more sim cards than people in the Cook Islands. The use of mobile technology can disrupt the current market. Vodafone Cook Islands has launched Mobile Money. When combined with extensive reach of mobile users in the outer Islands this presents the opportunity for Vodafone to stimulate the growth of financial services to the outer islands (Pa Enua). This level of reach and efficiency means Vodafone intends to be the dominant provider of these services to the Pa Enua. Vodafone wants to increase the use of its mobile money app but is hindered by 'know your customer' requirements. Additionally, photo ID requirements make it difficult for many to comply with these rules.

Base cost of credit

Impact on borrowing costs: High

The base cost of credit is one of the largest cost factors of interest rates charged, and includes deposit rates, borrowing rates, term deposit rates, and the rate at which banks can borrow.

In 2012 there was a gap of $15-$40 million between domestic deposits and lending. Offshore funding was used to fill this gap. The price charged by Australian parent banks for the funding was estimated to contribute up to 0.5 percent (of the five percent) of the nominal interest spread. This has been as high as one percent, but was expected to decline as the trend in local savings increased and demand for lending remained subdued.

A significant change has occurred since 2012. The expected trend for increased local savings and the decline in offshore funding has occurred, and the cost of paying interest on deposits has replaced offshore funding as a driver of the additional cost of borrowing in the Cook Islands. This excess acts as a drag on business and creates additional costs that cannot be recovered through lending. In October 2020, it was estimated that there was over $400 million in cash deposits compared to $277 million of lending.[35]

In 2020 the Costs of Borrowing report estimated that the average cost of funds for the banking sector in 2019 was 3.4 percent. This is based on the banks' interest expense, compared to their portfolio of term deposits and savings on their books, including the 2.9 percent return on deposits held overseas. The three Cook Islands banks were able to move these funds to overseas banks where they generated interest which earned $5.55 million.[36] It was identified during our stakeholder engagement, that Government contracts were significant, and could underpin a significant proportion of a bank's operational costs.

A downside of the monetary union with New Zealand is the minimal opportunity for the Cook Islands Government to influence the base cost of credit. The Cook Islands Government is unable to exercise monetary policy to directly affect interest rates. However, as noted later, access to grants and concessional finance can allow the Government to provide cheaper capital.

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[34] Okotai, P. (2020). *The Costs of Borrowing.* Page 26.
[35] Okotai, P. (2020). *The Costs of Borrowing.* Page 14.
[36] Okotai, P. (2020). *The Costs of Borrowing.* Page 15.

5.3 New driver identified in stakeholder engagement

Growing climate risk driving costs

During the stakeholder engagement, one interviewee identified the growing concern of climate change and the risk it has on the Cook Islands economy. A small remote nation like the Cook Islands is already vulnerable to the impacts of climate change, but is also exposed to the global impacts that will come. Many nations are now acting to reduce their global footprint or transition to a net zero economy. These transitions tend to need to be supported by significant investment, and often investment in unproductive assets to replace older assets. As concerns continue to escalate, and more investment is required, the cost of business is going up. Banks are now required to take this into consideration, when determining risk.

The market risk is increasing with climate change. As an island nation, the Cook Islands is at risk from rising sea levels. Climate change is adding to the costs for businesses. When businesses are taking out loans to invest in measures to combat climate change they are investing in non-productive assets. This is taken into account by the banks and is considered a risk of lending.

6 Recommendations

The 2012 Knowles review and the 2020 Costs of Borrowing report made recommendations that would make banking work better for the Cook Islands economy, including lowering interest rates and promoting economic activity.

This section provides a short summary of each of the recommendations made in 2012 and 2020. For the 2012 recommendations we identify the Government response and the actions that have been taken. For both the 2012 and 2020 recommendations, BERL provides views of the recommendations, and considers the applicability and potential for the recommendations to reduce interest rates and promote economic activity. The section concludes with recommendations based on stakeholder feedback during consultation, and BERL's recommendations.

6.1 Recommendations made in 2012

The Knowles 2012 review, identified that in the short to medium-term the key issues were to clear the overhang of non-performing loans and lower the costs of making loans. Additionally, that in the medium to long-term the major issue would be whether the Cook Islands could move from a developing economy banking system, to a developed country model. To achieve these changes Knowles made seven recommendations in three different categories:

- Dealing with non-performing loans
- Lowering lending costs
- Move to a first world banking system.

6.1.1 Non-performing loans

The Knowles 2012 review identified that "the economic consequences of having high levels of non-performing debt in an economy are significant. The absence of decisive action now will have an on-going impact on continued sustained economic growth and banking costs for many years to come."[37]

Recommendation one: That the Ministry of Finance establish a task force with an independent Chair that includes the Financial Secretary, Banking Regulator, a legal representative and the three bank CEOs (or their representative) to fully define the problem and recommend within 90 days an action plan that would reduce non-performing loans below five percent within 18 months.

Strategies suggested in the report included increasing liquidity of the lease market, by allowing a wider range of purchasers to buy leases on high value residences, and providing automatic approval of sale of businesses to non-residents for businesses that are security for non-performing loans.

Increasing the range of purchasers would provide the banks with a larger market for selling the leases used as security for non-performing loans. A larger market would increase demand and prices for lease sales. Pre-approval of buyers and fewer restrictions would make sales faster. Both of these strategies would make it easier to recover debt, reducing the risk of losses and the cost for lenders.

[37] Knowles, S. (2012). *Cook Islands Banking Review. July 2012.* Page 12.

Response and actions

In its response to the first recommendation, the Government acknowledged the level of non-performing loans, and the impact it has on the stability of the financial sector, and intended to reduce the level of non-performing loans. The Government committed to establishing a task force to look at the issue. The task force was to produce a report by the beginning of December 2013, recommending the way forward.

The taskforce was never established but the banks took it upon themselves to bring the issue under control as it was in their commercial interest.[38] As at March 2020, pre-COVID-19, the economy was performing strongly on the back of continued growth in tourism. Non-performing loans fell from 15 percent in 2012, and were recently as low as 3.7 percent.

Evaluation of future potential

The concerns regarding non-performing loans in 2012 were managed by the banks without Government intervention. In some ways, non-performing loans during difficult times give businesses the opportunity to continue trading, employing staff, and buying goods from local suppliers. This has wider direct, indirect and induced benefits for the Cook Islands economy.

The impact of COVID-19 has seen tourism numbers drop significantly, which has slowed the economy. It is likely that as the Cook Islands, and the tourism industry in particular, responds to COVID-19, non-performing loans will become an issue again. However, we see no reason why the banks could not reduce these again when the borders open.

6.1.2 Lowering lending costs

The cost of lending, and the banks' perceived risk of lending, was identified in the Knowles 2012 review as a major factor in the high interest rates. The Cook Islands stakeholders acknowledge that there is a slightly higher level of risk associated with lending in The Cook Islands than there is in New Zealand, but view the additional risk premium charged by the banks in The Cook Islands as difficult to justify.

Reducing the risk of losses for lenders was seen as a way to lower interest rates to borrowers. This was to be done by improving the ability of lenders to recover losses, and by better identifying the risk of borrowers. Additionally, the report recommended that a development bank not be set up to support higher risk developing industries.

Recommendation two: Reduce the cost and complexity of selling a property lease and registering a mortgage against that same lease through amending property laws to standardise the process of obtaining consents of landowners.

In 2012, and still true now, a large proportion of land owners live overseas. The lack of legal process for obtaining landowner consent had led to a situation where securing a mortgage over a lease, or moving a mortgage, was difficult and expensive.

The report suggests that 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).

This recommendation would have made it faster and easier to sell the leases that provide security over loans. Reducing the cost of recovery would lower the risk cost to lenders. Reducing the consent requirements would also lower the risk for potential buyers and make it easier for them to

[38] Cook Islands Government (2013). *Government Response to the 2012 Cook Islands Banking Review. August 2013.*

obtain a mortgage at a lower cost. This would increase the attractiveness of taking over an existing lease, and increase the prices received by banks when selling security to recover outstanding debt.

Response and actions

The Cook Islands Government agreed in principle with the recommendation, recognising the complexity of land ownership, and noted that “moving forward on this requires a standardisation of certain components of leases.”[39] The Government agreed that the Ministry of Justice, in consultation with other relevant stakeholders, would review current arrangements around land mortgages and provide an action plan by the end of 2013. However, no significant changes were made to the land laws to make transferring leases less complex and costly.

Evaluation of future potential

Land tenure is a contentious and complex issue that is politically sensitive. Fundamental changes to land tenure are unlikely. Reducing the cost and complexity of selling a property lease, and registering a mortgage against that lease through amending property laws to standardise the process of obtaining consents of landowners, remains an area where actions could reduce interest rates.

We appreciate that there is little appetite for major changes to the land tenure system. However, there are opportunities to make small changes to improve the system, and reduce the perceived risk, with the consequence of reducing the cost of risk included in interest rates. The Ministry of Justice land reform consultation is a positive step.

The current system continues to have a high number non-standardised leases with multiple owners and uncertain approval processes. Standardising this process, and gradually moving all leases into a common format, would remove some of the complications that come with the current tenure system.

Simplifying consent requirements for obtaining and transferring a lease would reduce the risk, and make it easier for buyers to obtain a mortgage with a lower administrative cost burden. This would increase the attractiveness of taking over an existing lease, increasing the prices received by banks when selling a lease to recover outstanding debt.

Recommendation three: Improve the enforceability of lending contracts by establishing bankruptcy provisions or alternative court processes.

When interviewed in 2012, the banks commented that there were no processes for enforcing court orders to repay personal debt. The report identified that “ideally such processes relating to personal debt would be codified through a bankruptcy law so an orderly consideration be made of what is the fairest way of dealing with a person’s assets when they get in a position where they can no longer pay back their loans.”[40]

The recommendation would have clarified repayment obligations. The intent of this provision would have made it easier and faster for banks to recover outstanding debts in a more formalised structure. This would have reduced the risk of losses to lenders and reduced the cost of borrowing. The bankruptcy process was also intended to support rehabilitation for the debtor so that after a defined period they could be discharged and resume normal commercial activity. This

[39] Cook Islands Government (2013). *Government response to the 2012 Cook Islands Banking Review. August 2013.* Page 7.

[40] Knowles, S. (2012). *Cook Islands Banking Review. July 2012.* Page 13.

would have allowed the borrower to clear debts from failed activities and enabled them to recommence borrowing to support new economic activities.

Response and actions

The Government agreed with recommendation three and committed to pursuing actions to establish provisions for residents to declare themselves insolvent and absolve themselves of debts. The Ministry of Justice was tasked with drafting the policy and a new insolvency act was to be presented to Parliament in 2014.

No action has been taken. The Costs of Borrowing report commented that "it is not clear what is stopping action on this issue except for the lack of clear policy direction to initiate it."[41]

Evaluation of future potential

While enforcing court orders would prioritise dealing with a debtor's assets, this would come with additional costs for banks. As the Costs of Borrowing report states although this would reduce some costs, it is much less of a factor for recovery costs compared to factors such as land tenure or investment laws. When someone is unable to make repayments the banks are unlikely to be repaid in full, regardless of whether that person can be declared bankrupt or not.

Bankruptcy law is unlikely to reduce the risk of default by borrowers, and therefore the cost of risk included in the interest rate is unlikely to change. However, bankruptcy laws could speed up the process for resolving outstanding loans, providing a small benefit to banks who could clear defaulted loans and claim security quicker than is currently the case.

The banks are aware of the reputational risk of forcing an individual into bankruptcy. It would be viewed negatively if one of the banks was to enforce bankruptcy on a customer.

Recommendation four: Banks establish a credit reference bureau, preferably linked to a New Zealand based bureau, so an individual's credit history would be available across both countries.

The recommendation was made that a credit bureau would provide information to banks to make better informed decisions. This would include information on whether individuals have outstanding debts and pay their bills on time, as well as the number of loans applied for. The recommendation for a New Zealand link was to allow for the history of people moving between New Zealand and The Cook Islands.

The credit bureau was intended to reduce the risk to lenders. Improved availability of an applicant's borrowing and repayment history would provide improved information to lenders that would reduce the risk and cost of lending and, as a result, the cost of borrowing.

Response and actions

The Government agreed in principle with the recommendation and through the FSC committed to discussions with banks to check the viability of such a bureau. This was to include a cost benefit analysis.

The Cook Islands Credit Bureau has been set up. All three banks and additional entities are affiliated. The Cook Islands Credit Bureau has arrangements with New Zealand and global credit bureau companies and is looking to grow its footprint.

Since this recommendation was made, the Cook Islands Ministry of Justice has introduced the Personal Property Securities Act 2017, which established the Cook Islands Personal Property

[41] Okotai, P. (2020). *The Costs of Borrowing.* Page 6.

Securities Registry (the registry). The registry provides better information to lenders as business and individuals register notices of security interests in moveable property, and can search for notices of other existing security interests. This has been particularly beneficial for second-hand sales.

Evaluation of future potential

The Cook Islands Credit Bureau has helped lower the transaction cost for banks to access credit information as this can now be done in one place, rather than having to check with each of the banks. If there is a debt registered with one bank, the borrower will not be offered credit by the other two banks. Use of the Cook Islands Credit Bureau has expanded outside of the banks and is used by large Cook Islands businesses. The Cook Islands Credit Bureau has improved knowledge across the banking sector, and reduced the risks of lending, by providing better quality and more consistent information.

The Cook Islands Credit Bureau links with Centrix in New Zealand. This reduces the risk of customers leaving debts in the Cook Islands and moving to New Zealand. Some interviewees indicated that the Cook Islands Credit Bureau is now seen as a threat to people's ability to access credit in the future, especially across countries. Improved information has reduced the perceived risk of lending.

Proposed ID laws should improve the Cook Islands Credit Bureau and address an issue of people using multiple names. The proposal would see every Cook Islander issued with a unique ID number and revolve a current issue which sees different names used on different forms of ID depending on where they are issued. This would strengthen all areas of the economy where information is shared.

Recommendation five: That the Government should not re-establish a development finance entity.

The rationale given was that, on balance, it was judged that the Cook Islands Government would be better to focus on improving the business environment for commercial banking rather than take the risks of involvement in development banking. The report identified that experiences of Government owned development banks in the Pacific Islands, and other developing countries, had typically been commercial failures with the occasional success.[42]

Response and actions

The Cook Islands Government agreed with the recommendation and did not intend to re-establish a development finance entity. The Government identified significant risks with the establishment of such a facility and determined that the risks associated with development finance should remain within the private sector.

Evaluation of future potential

We agree that the Government should not re-establish a development finance entity. The market is currently being met for the tourism industry and the industries that support tourism. There is currently limited demand for lending to develop alternative industries.

There is seen to be inadequate scope for developing industries, such as fishing or agriculture, that would require a development finance entity. As will be covered when addressing the Costs of

[42] Knowles, S. (2012). *Cook Islands Banking Review. July 2012.* Page 13.

Borrowing report recommendations, if the Cook Islands Government was interested in development finance, this could be done through one of the existing banks, most likely BCI.

6.1.3 Move to a first world banking system

The Knowles 2012 review identified that the Cook Islands banking sector had the characteristics of a developing economy banking sector rather than that of a developed country's banking sector. The ratios that measure what a customer pays were all below the Pacific countries the report compared the Cook Islands against.

The recommendations were intended to reduce the overhead costs of providing banking services in a small market, provide a wider range of products and greater international connections, and to make land laws better aligned with the needs of a first world banking system.

Recommendation Six: Provide a first world banking capability by establishing a new class of branch licence that allows for a fully integrated branch for a bank that has a New Zealand licence.

The report identified that integrating into the New Zealand system would allow Cook Islands customers to access current local banking services as well as the full range of New Zealand dollar denominated internet banking services and global connectivity.

It was assumed that ANZ or Westpac would move to this licence, providing personal and business customers with the same range of transaction and deposit products as are available in New Zealand. However, lending products would remain different, reflecting the different security structures, property laws, and cost of business in the Cook Islands.

This recommendation was intended to lower the overhead costs of banking in the Cook Islands. The number of jobs required for banking in the Cook Islands would reduce as a number of the roles could be covered by existing staff in New Zealand. The bank would also benefit from economies of scale, by spreading the costs of back office activities and systems across a greater customer base. The banks could have also used their existing systems, with some modifications, to provide services at a lower cost than a stand-alone bank in the Cook Islands. Allowing customers to pay directly into a New Zealand account would have also removed the transaction charges faced by businesses moving funds between New Zealand and the Cook Islands.

Response and actions

The Government agreed in principle and committed to research the implications. The FSC was tasked with taking the lead on researching and co-ordinating the Government response. The FSC was to present its recommendations by the end of 2013.

No concrete steps were taken and concerns were raised about the impact on the Cook Islands sovereignty and ability to regulate its own baking system. Additionally, none of the banks operating in the Cook Islands are headquartered in New Zealand and, with the exit of Westpac, only ANZ has operations in New Zealand.

In 2015, Buddle Findlay and Velocity New Zealand looked at the recommendation and found that while an integrated system might improve the transfer of funds, it was questionable whether Cook Islanders would transfer funds back to the Cook Islands and also whether having an account in New Zealand was attractive.[43] The Costs of Borrowing report found that the implementation of such an arrangement would be complex, and would involve costs that would outweigh the benefits.

[43] Buddle Findlay (2015). *Delivering a modern payments system to the Cook Islands: A report on the Cook Islands banks operating in the New Zealand payments system*.

Evaluation of future potential

It has been nine years since the Knowles 2012 review and New Zealand banks have shown little interest in the Cook Islands, noting that the Pacific banking environment is unique with different challenges and requirements when compared to New Zealand.

New Zealand banks are unlikely to take the risk in the Cook Islands when resources can be put to more productive uses in New Zealand. New Zealand banks would find it difficult to scale a product given the small market and the differences to New Zealand. It would be likely that a New Zealand bank intending to operate in the Cook Islands would need to set up a specialist unit to offer services.

New Zealand banks would face the same cost of risk pressures the Cook Islands banks currently experience and, if one was a new entrant to the Cook Islands market, it would increase the costs caused by the lack of scale by dividing an already small overbanked market even further.

Additionally, banks in New Zealand and Australia do not have the appetite to lend against leases. Personal loans would be easy to replicate in the Cook Islands, but banks see business and home loans as more difficult. It is likely an incentive would be required to attract a New Zealand bank, or to convince ANZ to change how it operates.

A concern was also raised that if a New Zealand bank operated in the Cook Islands, the people ultimately responsible for assessing the risk would remain outside the Cook Islands. The complaint has been that the ANZ and BSP risk assessors are not based in the Cook Islands and do not understand the market well enough.

It has been suggested that the Cook Islands could benefit from integration with the New Zealand settlements system. While all three banks noted that they could meet RBNZ requirements this comes with a trade-off between costs and need. At present, the current system is fit for purpose and does not impose additional costs on customers.

The cost of new back office systems would be passed onto consumers. Given the ongoing issues of scale this would restrict the banks' ability to lower lending costs, at least in the short to medium-term. Banks expect the extra demands of RBNZ would also increase compliance costs.

On the positive side, integration with New Zealand would remove international transfer fees. Removing this would make significant savings for the businesses that do not use New Zealand accounts.

Some interviewees expect that if the Cook Islands was integrated into New Zealand, BCI would become a tier two lender and act more like a credit union.

Recommendation seven: 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 land ownership.

The report identified the opportunity for the Cook Islands to unlock more economic potential from agricultural and tourism uses of land that would provide better returns for land owners.

The system in place had a high number of short term and non-standardised leases with multiple owners and uncertain approval processes. The author found this made the Cook Islands a relatively unattractive place to do business. It was noted that without change to land laws the contribution banking can make to develop the economy is constrained.

Much like other recommendations in 2012 that deal with land ownership and tenure, this recommendation would have made it easier for land or lease ownership to be transferred in response to a borrower being unable to make repayments. Any changes to property laws that make transferring land and registering a mortgage easier reduces the risk to banks, as well as the costs associated with selling the lease to recover any losses resulting from repayment failures.

Response and actions

The recommendation put the Cook Islands Government in a difficult position. While a review of the law has the potential to improve banking, it has the potential to put pressure on the Cook Islands hereditary system of land ownership. In its response, the Government committed to maintain the leasehold system of land use. However, the Government acknowledged the difficulties arising from the number of Cook Islanders residing overseas. MFEM and the Ministry of Justice were tasked with a preliminary review. The review was to report by June 2014.

As noted earlier there has been no change to the Cook Islands land ownership laws and there is unlikely to be any significant changes made in the near future. The most likely change would be to extend the length of lease made available to simplify the process for obtaining or transferring/selling a lease. It has been suggested that the maximum lease could be extended from 60 to 99 years.[44]

Evaluation of potential

Major changes to land tenure laws are unlikely. During discussions with interviewees, it quickly became clear that there was neither the local support nor political will for changing the land tenure system. The land tenure system has ensured that Cook Islanders have maintained a connection with, and control over, their customary lands. This has promoted social cohesion on the Islands when compared to other Pacific countries where traditional lands have been sold.

Land tenure is seen as positive, as it prevents people losing connection with their land. The example of Hawaii was given, where traditional land owners had sold traditional land, could not afford to live on the Islands, and were forced to move to California, or elsewhere in the USA.

Sixty years is seen as the sweet spot for land leases. It is viewed as a lifetime for both the owner of the land and the holder of the lease. The lease system allows the direct descendent land owners to retain control of lands, and correct any mistakes that were made by their parents or grandparents. For the lease holder this provides the opportunity to run a successful business for their lifetime, before it is returned to traditional ownership. A significant proportion of businesses, particularly on Rarotonga, are lifestyle businesses where a 60 year lease is more than suitable. In the event that leases are running to an end, or longer certainty is required, they can be renewed or extended. The proposal for a 99 year lease was considered to be two lifetimes, or the equivalent of freehold, restricting the ability of the next generation to determine the future of their traditional lands.

The lease system also promotes the joint relationship between the lease owner and the land owner. In most cases if a business is successful, when negotiations for an extension are required and the relationship remains strong, the land owner should be willing to extend the lease.

If the intent is to promote investment in the Cook Islands without significantly changing all land tenure laws, the suggestion was made for a carve out from the land tenure law that would allow a 99 year lease where there was significant investment potential that required additional certainty of

[44] Okotai, P. (2020). *The Costs of Borrowing.* Page 6.

tenure. This could be used for a nationally significant project, or to increase interest from large international investors. Longer leases would attract next level investors who do not want to deal with disputes between families and the need to renegotiate every five years.

Land reform consultations have been proposed. If these go ahead, it may lead to changes that reduce the risks associated with land tenure, which should further lead to reduced interest rates.

6.2 Recommendations made in 2020

The Costs of Borrowing report makes four recommendations for how the Cook Islands Government can ensure the cost of borrowing remains as low as possible.[45]

6.2.1 A banking policy that signals the Government's intent and vision

The report identifies the Government intent to keep the cost of borrowing as low as possible, while maintaining service standards. However, it suggests that the industry and public do not have a clear idea of the intent or vision for the banking sector. The authors believe a clear policy would do three things:

- Give direction to the banks (improving stability and certainty allowing them to plan and be proactive and responsive to Government policy)
- Empower the regulator, in terms of attracting resources and enhancing their status
- Focus Government and BCI and provide a clear mandate.

The third point is intended to create competitive pressures to reduce rates across the sector. The report identifies BCI as the vehicle to do this by focussing on cost reduction to decrease rates.

Evaluation of potential

A specific banking policy is unlikely to reduce the cost of borrowing. Despite not having an official policy the Cook Islands Government has been clear for over a decade that it wants to see interest rates decrease. Reducing non-performing loans was a priority after the 2012 review and the banks have made progress without a clear policy.

Competitive pressures led by BCI are unlikely to decrease rates. ANZ, and to a lesser extent BSP, can spread costs across larger networks. BCI has the highest operating cost, and least ability to spread these risks. Without Government capital input, BCI would likely be the first bank to collapse if it entered into price competition.

If costs are going to drive a reduction of interest rates, the Cook Islands need to achieve economies of scale. Three full service banks serve a population the equivalent of Mosgiel or Tokoroa. To provide context Tokoroa has four branches and Mosgiel has two.

The greatest potential from decreasing costs comes from reducing duplication across the banking sector, rather than BCI leading price competition by reducing costs.

The majority of the interviewees were of the opinion that the FSC are doing the job they were intended to do, and that a Government policy is unlikely to empower them any further. It was suggested by interviewees that more weight for the FSC to conduct enforcement would benefit consumers. However, this would require more resources for the FSC and could cause extra compliance costs for banks.

[45] Okotai, P. (2020). *The Costs of Borrowing.* Page 27

6.2.2 Government to implement disciplined fiscal policy to pay down debt

As identified earlier, an important component of the base credit cost is the sovereign credit rating. COVID-19 has required the Cook Islands Government to borrow heavily to keep the economy afloat. Reducing debt will require a disciplined fiscal strategy. If the Government can balance stimulating the economy while reducing debt, it can improve the country's credit rating and lower its interest rates.

Evaluation of potential

The Government is aware of the need to implement disciplined fiscal policy and the need to pay down debt. COVID-19 has drained Government reserves accumulated from average budget surpluses of five percent from 2016 to 2019.[46] The support the Government has provided will enable the tourism sector to quickly restart once health concerns abate. This will support the Cook Islands recovery and allow the Government to begin repaying debt. As well as generating tax income for the Government, if tourism can quickly restart GDP can begin to recover which will reduce the increased Cook Islands debt to GDP ratio.

The 2020 Asian Development Bank (ADB) debt sustainability analysis for the Cook Islands expected real GDP to contract by seven percent in 2020 and over 15 percent in 2021.[47] This is compared to 6.3 percent average annual growth between 2015 and 2019. However, before the emergence of the Omicron variant the ADB expected GDP growth to rebound over the medium-term, to 17 percent in 2022 and 11 percent in 2023. After budget deficits in 2020 and 2021, the Government's fiscal position is expected to return to a 2.2 percent average surplus in 2023 to 2024.[48]

6.2.3 Investment in new sectors to diversify the economy

As identified earlier, the concentration of tourism is one of the inputs into the banks calculation of risk. COVID-19 has demonstrated the impact of a lack of tourism. The report recommends a policy and strategy to diversify the economy as doing so will diversify the banking portfolio, and reduce the risk of the Cook Islands as a whole.

Evaluation of potential

The view of interviewees is that opportunities for economic diversification are limited. Tourism is seen by many, as the most profitable industry and the one with the greatest opportunities. Land scarcity, particularly on Rarotonga, incentivises the use of land for tourism activities. Even small accommodation providers, such as small family businesses with two or three villas, were making good returns before the borders closed. The opportunity cost of this is the use of land for other activities such as agriculture. On the outer islands, where demand for tourism is lower, there is more possibility for other activities.

The Costs of Borrowing report suggested promoting investment in agriculture and fishing. Economies of scale, and the costs of labour and transport, are some of the factors that mean that the Cook Islands cannot compete with other Pacific Island countries in these two industries. Interviewees identified New Zealand's strict bio-security laws as an impediment for small local producers to export to what would be the most obvious destination.

[46] Asian Development Bank (2020). *COVID-19 Active Response and Economic Support Program: Report and Recommendation of the President. Cook Islands: debt sustainability analysis.* Page 1.

[47] Asian Development Bank (2020). *COVID-19 Active Response and Economic Support Program: Report and Recommendation of the President. Cook Islands: debt sustainability analysis.* Page 1.

[48] Asian Development Bank (2020). *COVID-19 Active Response and Economic Support Program: Report and Recommendation of the President. Cook Islands: debt sustainability analysis.* Page 1.

Often agricultural producers are lifestyle businesses which produce and sell enough to support and maintain a comfortable lifestyle. Agricultural products grown in the Cook Islands are commonly sold to locals and tourists who want fresh local produce. The Food and Agriculture Organisation of the United Nations has stated that "considering population trends in the country, the domestic labour pool is not likely to grow in the foreseeable future."[49]

In terms of fishing, the Cook Islands are a high cost location for operating longline tuna vessels, and labour for industrial-scale tuna fishing is scarce. Domestic fishing is predominantly charter fishing for tourists or subsistence fishing for local residents. Commercial fishing around the islands is done by foreign ships, crewed by foreign staff, who buy quotas from the Cook Islands.

Seabed mining was identified by the majority of interviewees. However, this is likely to be in the form of licences to foreign companies. The income to the Cook Islands Government from licences to mine would have indirect and induced benefits. It is unlikely to create significant direct Cook Islands employment and GDP, or significantly reduce domestic interest rates.

Education has been suggested as a way to diversify. This could be done in two ways. The first would be to better educate the population and export skilled people into well-paying roles in New Zealand and Australia. Longer term this would increase remittances back to the Cook Islands. The second was to make the Cook Islands a centre for marine education, with a focus on climate change and impacts on the Pacific. It was suggested that a campus for a New Zealand university could be established and students could spend time studying in the Cook Islands.

Finally one interviewee mentioned that the lower minimum wage in the Cook Islands when compared to New Zealand, and the new internet cable, could make the Cook Islands an attractive place for call centres.

6.2.4 Explore the feasibility of a special purpose vehicle to encourage economic diversification

To support diversification the Costs of Borrowing report recommends creating an enabling environment with access to affordable finance. This includes recommending a dedicated study of the optimal conditions to introduce concessional finance to service an economic policy aspiration of "growth and diversification."

Evaluation of potential

As noted earlier there are limited opportunities for economic diversification. If the economy is unlikely to diversify, the need for a special purpose vehicle is limited. If tourism is successful then other industries are likely to also be successful. Given the strong links all industries have with tourism, and its importance to the Cook Islands economy, the commercial banks are likely to provide finance if they see the risk is acceptable.

Establishing a development bank was recommended against in 2012. If the Government wants to promote investment in a more diverse range of industries this could be done at a lower cost in partnership with the commercial banks. BCI would be the obvious example.

The Costs of Borrowing report suggests an existing bank should manage the funds with a specific mandate, and a minimal return on investment, to keep the costs of funds low. Whether there is

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[49] Food and Agriculture Organisation of the United Nations (2021). *Fishery and Aquaculture Country Profiles. Cook Islands.*

demand for investment from developing sectors is unclear. There is scepticism amongst the banking sector that there is significant interest in non-tourism related commercial opportunities.

6.3 Next steps

This work is intended to inform further discussions of the policy, regulatory, operational, and technical options available to the Cook Islands and RBNZ. Some of the options may require small interventions, while others may be more ambitious. To support these discussions BERL has identified four areas where we see opportunities to promote the prosperity and wellbeing of Cook Islanders and reduce lending rates. We start from the theoretical premise that land tenure laws are unlikely to change and that the size of the economy is negatively correlated with risk, confirming the importance of scale.

6.3.1 Reduce the impact of scale

What remains clear is that the Cook Islands banking market faces a problem with scale. Addressing scale has the greatest potential to reduce rates. This was identified in the 2012 review and the Costs of Borrowing report, and there was unanimous interviewee agreement that scale was a major factor causing high interest rates.

Large scale improvements to counter scale are likely to require a reshaping of the market. The view amongst interviewees is that the Cook Islands has at least one bank too many. A banking partner from a big four accounting firm estimates that a bank in the Cook Islands would need to be $300-$400 million to be economic. If this occurred, and debt collection could be cleaned up, the banking partner estimated the margin could drop by two percent.

Although BCI has led with rate rises it has the least ability to spread costs. If BCI is to lead interest rate reductions it needs to increase its size, spread costs across a larger customer base, and invest in systems to make processes more efficient. More Government contracts, including the use of BCI for Government banking and investing in Government infrastructure projects, would support BCI to grow.

If the Government increased its use of BCI it could support the bank to grow, increase its profitability and reduce rates for customers. Increased Government banking would show other potential borrowers that BCI can meet the needs of large customers and attract customers from the other banks.

Technology and new services present an opportunity to reduce operational costs while improving the banking to underserved parts of the community. The Asian Development Bank refers to the need for a state owned bank when it adds value to the sector by providing new services or products, or providing access to underserved parts of the economy.[50] With Government support, BCI could develop and promote the uptake of mobile and online banking and the introduction of new services.

As shareholder, the Cook Islands Government could make a capital investment in BCI. This would stop the additional cost of technology upgrades and development from being passed on to customers.

[50] Asian Development Bank (2019). *Finding Balance 2019: Benchmarking the Performance of State-Owned Banks in the Pacific.*

6.3.2 Better financial education

Improving the overall financial literacy of the Cook Islands would reduce the perception of risk and the cost passed on through interest rates. If people were better educated and understood the potential impacts and consequences of the loans they were entering into it would reduce the level of defaults.

At a corporate level, businesses with improved corporate governance have received improved loan rates from banks. If corporate governance could be improved, theory suggests that so would business performance. A number of the businesses in the Cook Islands are lifestyle businesses. It would be highly beneficial for these businesses to have access to support to improve corporate governance and meet the reporting requirements of the banks. This would allow for higher quality information flow to the banks, reducing lending risk.

6.3.3 Promote technology uptake

Technology is seen as a way to reduce the cost of banking. While technology has been slower to reach the Cook Islands than other parts of the world, the Cook Islands is in a position to embrace increased online banking. If more customers were using online services it would reduce the need for branch services and enable banks to reduce these overhead costs.

Support could be provided to promote the uptake of technology and online banking amongst the older population. For example, debit cards instead of EFTPOS or cheques would reduce the need for businesses to carry multiple card readers for different banks and reduce manual cheque processing costs. Increasing the use of online banking and increased card use could reduce branch costs, particularly for BCI.

With financial services becoming a more significant part of the Vodafone service, offering appropriate technology and infrastructure will be deployed and evolved to support the services.

6.3.4 Promote alternative forms of lending

Alternative approaches to lending could be made available in the Cook Islands, and technology is making this easier. Peer to peer lending, using technology to match lenders with borrowers, has emerged globally and includes platforms like Peerform, Upstart and Prosper.

Cook Islands deposits are greater than lending. Peer to peer lending in the Cook Islands could cut out the banks and enable Cook Islanders, with savings, to lend to Cook Islanders who need to borrow. If implemented correctly, returns for depositors could be greater than bank deposit rates and interest rates could be lower than bank interest rates. If lenders and borrowers can meet in the middle, both benefit. This would put pressure on banks to improve interest rates. However, it is important to note that alternative forms of lending are not without their own difficulties and challenges that would need to be managed, including the potential to increase the impact of lack of scale.

Appendix A References

Interest rate data

The following provides detail on the differences in types of loans between the Cook Islands and New Zealand banks, and sources for finding the interest rates included in Table 3.1. It is important to note that rates vary on circumstances, and vary even more so between the two different economies for a range of reasons.

The Cook Islands interest rates

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Financial soundness indicators

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