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# FINDING HYBRID SOLUTIONS to the FINANCIAL MANAGEMENT of CUSTOMARY LAND from a PACIFIC PERSPECTIVE

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### ■ Abstract

Within contemporary society, customary land is at the nexus of culture and commercialisation. Tasked with facilitating market-based returns on customary land whilst promoting equitable inter and intra-generational sharing of returns, this paper reports a solutions-based research project that investigated and tested a range of hybrid models in the Pacific context. The challenges are diverse, in many cases confronted by the Western approach, which identifies property and ownership as something to address in a businesslike way. Accepting the notion of ongoing Indigenous guardianship of land as sacrosanct and that de Soto's privatisation model is an unacceptable simplification, this paper offers innovative regional examples of customary land administration/management arrangements in encouraging equitable use of customary land by both members and non-members of land "owning" groups.

Land is the foundation for the lives and cultures of Indigenous peoples the world over. Without access to and rights over their land and natural resources, Indigenous peoples' distinct cultures, and the possibility of determining their own development and future, become eroded (Jensen, 2004, p. 4).

### ■ Introduction

This paper engages the critical question, "how best to manage customary land in contemporary society"? It tackles this challenging topic through the financial management of land by our Pacific neighbours, where naivety in preparing leases by customary owners and their government advisers risks minimising the intergenerational benefits and returns that should otherwise be forthcoming from customary land. Land and rights over land are a controversial issue in all societies. As Bromley (1991) highlights, there are few concepts in economics that are more central, or more confused, than those of property, rights, and in particular property rights.

When discussing property rights, I prefer the sentiments of the high context "Indigenous relationship to land", as described through Larissa Behrendt's (2003) recollections of her fathers description of a cultural relationship to land:

We bond with the universe and the land and everything that exists on the land. Everyone is bonded to everything. Ownership for the white people is something on a piece of paper. We have a different system. You can no more sell our land than sell the sky. Our affinity with land is like the bonding between a parent and a child. You have responsibilities and obligations to look after and care for a child. You can speak for a child. But you don't own a child (p. 33).

This example highlights the essential Indigenous notion of guardianship.

### ■ Land in the Pacific

Land, or more correctly the lack of clearly defined property rights to land and the resources associated with access, is commonly cited as a major cause of dispute and resultant instability in the developing island nations of the South Pacific region. Land is different in the South Pacific in that the majority of it was not alienated under colonisation, in contrast

This does not necessitate freehold, as some suggest, but it does require well-defined leases over customary land. A central part of the financial relationship between customary owners and their tenants concerns the long-term trends in the lease relationship.

### ■ Finding leasehold solutions

The simple dictionary definition of a lease is a “contract by which one party conveys land, property, services etc. to another for a specified time, usually in return for a periodic payment” (Oxford Dictionary of English, 2003, p. 996). A lease is a proprietary interest in land that provides property rights to temporarily pass on to another party for a term of years absolute (i.e., a fixed term estate) in the land/property in return for equitable rental payment. The purpose of leases is to create an opportunity for those who hold a “superior” interest in land (i.e., the customary “owners”) to provide access to land for those who have the capacity to make it economically productive (i.e., tenants). The equitable rent is, taking the Ricardian model, the surplus of productivity from the land having taken out the costs of production and labour on the part of the tenant.

The opportunity to liberate access to land for a term of years absolute to enable economic production through leasehold structures that retain the superior property rights in the customary “owners” is the accepted solution in the Pacific. Leasehold structures are located between the extremes of the unacceptable “do nothing” and “privatisation” models. Leasehold models are, of course, already in place in the Pacific, ranging from 20+20 year residential leases, 30+30 tourism leases, and other variations for 50, 75 and 99 year terms.

In order to avoid, or significantly minimise the risk of, future conflict it is essential to manage the adoption and implementation of the fixed term leasehold estates very carefully. At the outset, it has to be stated that the term of years absolute approach is not without its limitations, problems, and challenges. It is important to recognise and learn from the lessons experienced in managing leasehold interests in other countries where they have been applied in various ways for far longer. In the UK for example, where 30% of household tenure is leasehold (and most commercial) there is increasing “disenchantment with fixed-term leasehold estate as a medium of residential ownership” (Gray & Gray, 2005, p. 458). It is argued that the leasehold system, having its roots in the feudal system has benefited the residential landlord, whilst leaving the tenant with a wasting asset. In response, the government has approved the *Commonhold and Leasehold Reform Act* (2002) to enable owners of flats/units in apartments to own a perpetual interest. This follows 35 years of ongoing residential leasehold reform legislation dealing with the expiry of 99-year Victorian leases (from 1967

*Leasehold Reform Act*). Lessons from these examples are incorporated in the solutions below.

In the Pacific, there remain differences of public perception between leaseholds offered on government or freehold land alienated during colonial rule, compared to those offered on customary land. This is a curious anomaly, given that it is the role of the State to guarantee all formalised property rights over registered or recorded land. This anomaly is compounded, in part, by the adoption of a regulated rental basis that is grounded on the hypothetical construct of unimproved capital value (UCV).

UCV is hypothetical to the extent that immature Pacific property markets, with small largely urbanised pockets of Freehold land, do not have adequate comparative transactional sales data on which to ground their analysis (which is quite understandable, given that the superior interest in customary/familial/clan/tribal land cannot be alienated and sold on the open market). The tone of the unimproved capital value list, which has been developed for both urban and rural land in Pacific Island Countries where the majority of land remains vested in the customary owners, has variously been decided upon by a panel of local valuers on behalf of the Minister of Lands (e.g., Fiji) or by external consultants (e.g., the model developed for Honiara, Solomon Islands). The UCV provides a convenient statutory benchmark, and is easy to apply in circumstances of limited valuation capacity where its application becomes a clerical task.

Examples of UCV models largely assume that the land has not been developed for economic gain, but in the models adopted locational factors (e.g., proximity to the central business area, quality of roads and access) is reflected, as are generalisations of soil quality, slope and productive capacity in providing a valuation “tone” in rural areas. These models of UCV are reviewed periodically, usually at intervals of more than five years.

A discount rate is applied to the UCV of the land to determine the annual ground rent applied to a particular parcel. The statutory ground rental rates vary between 5% (e.g., PNG) to 6% (e.g., Fiji, Solomon Islands), and apply to both government and customary land. However, it is common to find that far lower percentages are applied than those permitted under various country legislation. For example, in Fiji the maximum rent under both the *Agricultural Landlord and Tenant Act* (ALTA) and the *Native Land Trust Act* (NLTA) is 6% of the UCV. In practice, the Native Land Trust Board (NLTB) as Trustee of the customary owners only collects 2½-3% of UCV, because the State as a matter of informal policy collects this much, or less, under their ALTA leases. The situation is similar in the recent UCV model developed in Honiara, Solomon Islands, where the Valuer General’s office has charged as low as ½-3% of UCV on urban government land, based on reasonableness and affordability.

These variations in regulated rentals raise several issues. These include a belief by some in government that 6% of UCV is not affordable. Does this mean 6% is too high, or the UCV is too high, and who could tell in a market skewed by limited access to freehold or perpetual estate title? This situation also opens potential for corruption if deals are negotiated at less than 6%, albeit that the benevolent actions of the government in charging less than the prescribed maximum serve to liberate access to land at a level that provides some social support. Complications, and resultant conflicts, will inevitably arise in the future (taking a 50-75 year time horizon) when available urban land is in short supply and the land value is at a premium. There are also problems for trustees (e.g., NLTB) of customary land in attracting tenants if they are charging the statutory rate (6%) and the government is charging half of this (3%). Moreover, there is a risk of the government or appointed trustee being sued at some future point for charging less than statutory maximum rental.

Another related challenge for UCV is that it is also adopted as the benchmark for municipal rates for services in certain urbanised areas in the Pacific, again with notional 5-6% being applied as the rateable component. This double application of the hypothetical UCV in the determination of both regulated ground rent and municipal rates adds to the confusion. A criticism of the UCV approach from a landowner or customary owner's perspective is that the resultant regulated rentals do not keep pace with the increasing value of land over time, despite inbuilt review clauses. A solution to this is to move towards a valuation model that reflects an equitable share of the improved market value returns to the landowner either at the end of the lease, or during the currency of the lease. However, we cannot integrate this solution without first providing background to a range of related leasehold issues. It is one thing to generate leases to liberate access and related fixed term use rights to others, but it is critical to think ahead about future issues that will affect the lease, use, and rights of the parties, such as:

- **Default on rent by tenant** – Under what circumstances can the trustee or landowner reclaim the land and any improvements thereon in the event of non-payment of rent or other charge on the property? It needs to be noted that there are cultural and value issues surrounding the repossession of customary land. Certain of the banks have also identified these cultural issues as impediments to lending on any title over customary land. Lending institutions see the risk of negative media attention associated with dealing with repossession over customary land as outweighing their financial gains in providing lending for this class of ownership.
- **Death of tenant** – What provisions are in place for the passing of the tenant? Will the lease convey

to their spouse (who is often not named as a joint-tenant or tenant-in-common) and/or their children? The circumstances surrounding the death of a landowner are not usually an issue, as long as the leasehold arrangement is formalised with a trustee, the land is registered or recorded in some way, and the arrangement is backed by the State. This highlights the potential risks experienced in informal lease or informal tenancy arrangements.

- **Expiry of lease** – This is a major issue and one that has already caused major conflict (e.g., the recent expiration of sugar cane leases in Fiji). However, the cane lease example is small scale compared to the impending expiration of residential leases in urbanised areas of Fiji. Whilst it has been accepted practice for the government or NLTB to negotiate an extension (arguably a surrender and renewal) of leases in the latter part of their term, there is a major uncertainty about the ownership of tenant's improvements on expiration (see "Improvements" below). Hitherto, the only benefit in granting an extension of the lease term is to ensure a continuation of tenancy at a renewed ground rent (albeit at 3-6% of UCV). However, given the ownership of any improvements on the land being vested in the tenant, a legal challenge is impending over what rental should be charged on lease renewal, given that the landlord (e.g., NLTB as the trustee) could demand that the land be returned in the condition that it was in at lease commencement. There is obviously a need to find an equitable legal compromise before expiration.
- **Improvements on land** – "[T]he concept of improvements to land is a Western law concept and may not apply to customary land or may apply but not in the way in which it is applied to Western property" (personal communication, May 14, 2007). Given the extensive experience of lease expiration in England, the issue of improvements is considered below as it applies to residential leases (Fiji) and tourism leases (Samoa). The issue surrounds a level of ambiguity evidenced in leases for land for both residential and tourism purposes, and how leases have arguably adopted more of an Australian rather than English approach in managing improvements.

#### ■ Learning from past lease expiration

By way of background, as English towns and cities grew during the 18th and 19th century, landowners optimised the financial gains from letting land to builders rather than less profitable farming tenants (George, 1992). These were "building" leases, with premiums paid at lease commencement and thereafter a low or nominal ground rent (similar to the ½-6% of UCV variously applied in Pacific Island countries). Where they differed from the current Pacific examples

is that builders developed the land, and then sold the land and buildings by way of a sublease for the unexpired term of the lease (commonly 95-97 years). However, the leases were clear that the approved improvements were to be returned to the landlord in good and tenantable repair at lease expiry. Details of the approved “tenants improvements” undertaken by the builder, along with a comprehensive building plan, were included with the lease documentation.

Obviously, with the granting of a 99-year lease, there is little concern in the early years of tenancy regarding the “wasting asset” nature of a term of years absolute (see Figure 1). Indeed, given the time-preference of money, in valuation terms there is not a significant difference in the right to receive rental for 99 years or for perpetuity. This is not the case as the lease progresses, and particularly in the last 25-30 years of the term, when it becomes difficult to secure mortgage funding (with no lender prepared to lend beyond the expiration of a terminating lease). The large numbers of these building leases that were due to expire in the 1970s-1990s was in no small part a factor in the degeneration of inner urban areas England at that time. Given the uncertainty of lease renewal and the declining value of the tenants interest in the wasting asset, there was no incentive to maintain or inject capital into the improvements.

Politically a range of issues emanate out of the UK example, with tenants seen as victims and local governments faced with urban decay attributable to the leasehold regime. The response, in a country where the dominant tenure is freehold, was to enact legislation to allow enfranchisement enabling tenants to acquire the freehold interest through a formula-based payment that compensated the landlord for improvements with a discount based on length of occupancy (to avoid speculation), or obtain an extension of the lease on “fair” market based terms. Obviously, unlike the Pacific, it was easier to determine market value in England in circumstances where 70% of the comparable evidence was freehold title. This example highlights an untenable outcome in the present political climate of the Pacific where the continuance of customary land as the superior interest is inviolable. The solutions detailed below recognise that circumstance.

The Pacific needs to learn from the lesson that it took the UK some 35 years to reconcile the challenge of leasehold ownership that commenced with the granting of 99-year leases over a century ago, and that the solution (enfranchisement of freehold interest) is inappropriate to the continued customary ownership of land.

A key lesson is that the English building lease model was clear on the issue of improvements – they belonged to the landowner on lease expiry and were to be returned in good and tenantable repair as compensation for the land having been tied up at a low/nominal rent for 99 years. This ensured some

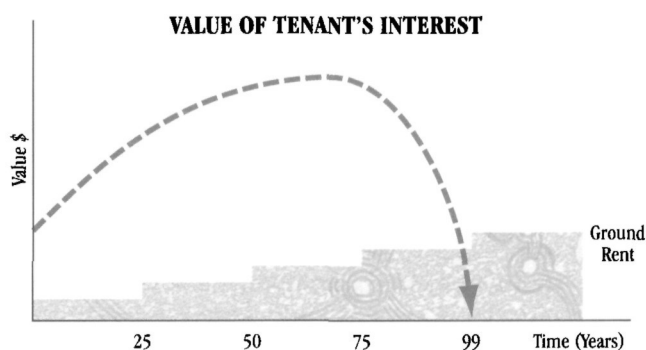


Figure 1: Leasehold interests as a wasting asset.

intergenerational equity for the landowners (albeit that in many examples the landowner comprised the “city fathers” and so there were political implications to reconcile at the level of local government).

As introduced above, for the purposes of this paper, two types of lease in the Pacific are investigated: Residential and Tourism, as both of these are the inevitable causes of future conflict unless intervening action and education can be made in the short term. The residential leases in Fiji fail to address the question of who owns the property rights in the improvements on lease expiry (Boydell & Shah, 2003). The commonly adopted wording in the leases is that any improvement erected by the lessee (tenant) on the land shall be removed within three months of the expiry of the lease. There is a provision for the lessee (landlord) to purchase the improvement (building) upon payment of fair value to the lessee. These clearly defined property rights (separating land as the landlords interest and the building as a tenants interest) will lead to inevitable confusion and uncertainty as the term of years absolute expires. This is quite different to the English example, where the lease clearly places the onus on the tenant to return the well-maintained improvements as well as the land component to the landlord at lease expiry.

#### ■ Residential leases in Fiji

What is the solution? Take the example of the 18,000 (approx.) residential leases granted by the Native Land Trust Board over customary land in predominantly urbanised areas of Fiji. The general perception of customary landowners (as opposed to their actual legal situation) is that they have received a very small rent whilst their land has been tied up for 60 plus years, and that the improvements will be their residual compensation. Their economic situation has not improved in line with the significant increase in value of the developed land in which they hold the superior interest. To date, as mentioned above, where a residential tenant has approached the NLTB for a lease extension, it has usually been granted without regard to any value in the improvements. However,

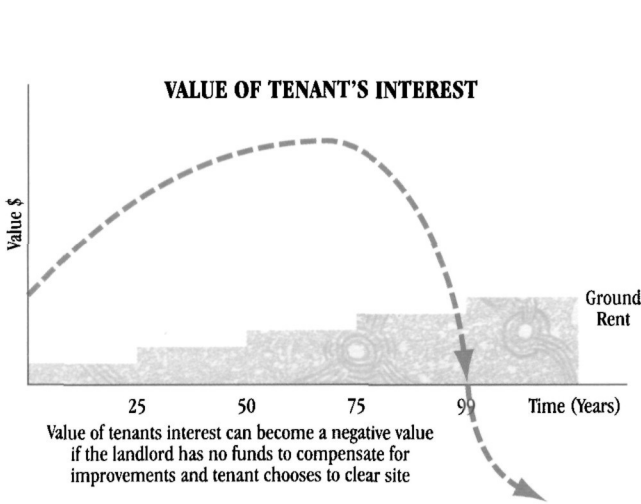


Figure 2: Tenants interest becomes negative at lease expiry.

as witnessed by the reaction to the expiry of cane leases, the landowners may assert their authority to take back possession of the land on expiration of residential leases. In Fiji, landowners are also aware that in 2000 the then Chaudhry Government took the unprecedented step of compensating agricultural tenants with the sum of \$28,000 on lease expiry to allow them to find alternative land and work. Following through the residential scenario, it is within the property rights of the landowners to retake ownership of their land on lease expiry. This results in one of two options:

- a) the outgoing tenant has to clear all improvements off the land (and thus pay the expense of demolition and remediation) making the value of the improvements effectively a negative in the final days of the lease (see Figure 2).
- b) the landowners have to compensate the tenant for the value of the improvements, and then they hypothetically have the opportunity to relet the land and improvements (as a single interest) at market rent. This assumes that the landlord (NLTB as trustee or the landowners themselves) has the money available to compensate the outgoing tenant for the improvements. Given there have been no "sinking fund" provisions made to accumulate capital for this circumstance, understandable as the ground rent model (up to 6% of UCV) bears no relationship to the market value of the land and improvements, no capital is in place to achieve this. If there is no capital available, does this force the landlord (or trustee) to have no option other than to grant a lease renewal/extension? Not necessarily, as they can request that the site be cleared and remediated – a circumstance where all parties appear to lose. If the NLTB did have capital to compensate the existing tenant for improvements

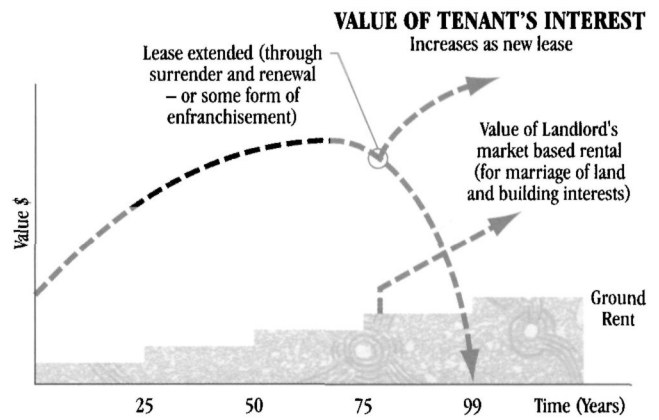


Figure 3: Marriage value of landlord and tenants interest on lease expiry (assuming continued tenant occupation and no compensation).

on expiry, there are further complications for what would follow. As far as granting a new lease is concerned, currently there is legislation in place for a short term tenancy arrangement, but not for a long lease with either a sale of lease (with improvements) with payment up-front, or a regularly reviewed residential tenancy to market rent.

The residential lease expiry solution is to "marry" the interests of the landlord (land) and the tenant (improvements) to allow continued economic use of the land (Figure 3). This model reduces the risk of leasehold blight and resultant urban decay or shortage of homes. It will allow the tenant to reinvest in the property once the lease is extended. The model will negatively affect the value of the tenants interest temporarily to reflect the increased rental payable to the landlord through the marriage value generated by joining the interest in the land with the interest in the improvement. However, the value of the tenants interest will be enhanced at subsequent assignment through the ability to secure mortgage funding in the long term. Whilst there is potential to develop a model where a lease renewal is generated upon payment of a premium (rent up-front), the annual rental model ensures that the landlord receives an equitable return without prejudicing intergenerational returns.

This model obviously creates an increased management role in administering the asset (now comprising land and building), something that in the case of customary land in Fiji the NLTB does not have the current capacity to manage. Obviously, the management fee for land plus improvements should be higher than mere land, and the model must incorporate a sinking fund for replacement of the improvements in due course. This is a hybrid model, and differs significantly from the UK example as it allows for the continued interest in the superior title to be vested in the customary owners.

The model will require the development of a valuation methodology to manage the marriage value calculation. Provisionally this can be calculated on the capitalised income for an open market transaction for a residential investment (and there is adequate market evidence upon which to base this in all Pacific Island countries), with a present value adjustment to reflect the number of years to lease expiry. The value can be moderated through a calculation of the value of tenants improvements (depreciated replacement cost) less cost of demolition and remediation. Valuation and legal costs related to undertaking the valuation and lease renewal should be levied on the tenants, given that if left to lease expiry their interest will fall to zero.

Critical to the execution of this solution is the need to minimise future conflict. Assuming a long lease is granted, given that both the land and improvements will now be vested in the landowner, there will be intergenerational equity ensured from the market mediated rental payment. Dependent on the length of the remaining lease at "marriage", the tenant will retain a level of profit rent for their interest, which can be transacted on the open market upon assignment of tenants interest to another party.

The model effectively moves, over time, an increasing share of the interest in the improvements to the landlord (i.e., the trustee on behalf of the custom owners). This brings a new set of rights, obligations, and restrictions onto the landowners to ensure that the property is well maintained and regularly renovated to capture the maximum return on the investment. There are associated insurance and maintenance covenants to address.

Such a model will inevitably provoke a range of reactions. Firstly, the tenants will feel aggrieved that they have a lesser interest under the new model. In reality, they currently have no property rights at all beyond the expiry of their current lease other than having a negative financial obligation to clear and remediate the site within three months. Under this proposal, they will have continued opportunities for living in the same property, albeit with adjusted property rights and as true tenants rather than the rather confused and misplaced perception of owners with right of renewal that exists at present. Critically, in the Fiji example, the 18,000 families affected are an important voting block in urban areas, so the information and education programme to inform each party of their rights will require careful political management. The alternative, of course, is the unacceptable move to permanent alienation by way of individualised freehold interests, breaking fee simple ownership away from the customary stewards. The political management to achieve that would be insurmountable at the current time.

As stated, there are major limitations in valuation capacity to manage this model at present. Leasehold

valuation models have been an ongoing source of contention in the UK (e.g., Baum & Crosby, 1988; Gane, 1995; Mackmin, 1995; Trott, 1980, 1986) because of: the adoption of low accumulative rates in the dual rate approach; remunerative rates that relate to the differing implied growth in freeholds; confusion of taxation adjustments; difficulties in adjusting for variable profit rents; the complexity of gearing; and, the major challenges in comparative analysis of leasehold sales. Moreover, managing the interest during a lease renewal will require a good understanding of leasehold valuation, particularly as the level of ownership in the landlord's interest moves firmly towards the full ownership of land and improvements. Caution will be required to prevent the limitations of valuation theory repeating the challenges experienced in the English system in the 1980s and 1990s.

### ■ Tourism leases in Samoa

Critical to minimising future conflict of the type detailed above, it is important to ensure that all new leases are drafted to vest improvements in the landowner on lease expiry. This leads into the challenge of Tourism leases in Samoa. A poignant example is provided in a recently negotiated lease for a new tourism development to take place on land that is customary familial with multiple ownership on the southern coast of Upolu in Samoa.

The proposal relates to a prime tourism development site of some 7 hectares. The chiefs of the familial owners appear to have been seduced by a modest ex gratia payment (that could be equated to "key money" or an initial premium) and, after a development grace period, a rental that equates to some 5% of a hypothetical UCV that was calculated at a nominal rural land use basis. Whilst the lease provides for first preference to be given for the future employment of "suitably qualified" applicants from the families whose land is used, this relates to low-end service sector employment in construction, maintenance, supply of goods, and handicrafts, as well as cultural demonstrations and car hire.

The lease, which is for 30 plus 30 years, contains similar provisions relating to the tenants ownership of improvements (and right to clear or be compensated on lease expiry) to the Fiji residential example described above. This means that the land is tied up for 30 + 30 years at a nominal ground rent which if cautiously invested at an accumulative rate could never generate a sinking fund sufficient to compensate the tenants for their tourism infrastructure improvements on lease expiry.

The customary familial interests are represented in trust, and administered by the Minister of Natural Resources and the Environment as trustee. The lease is therefore drafted between the Honourable Minister of Natural Resources as lessor and the tourism developer/

operator as lessee. Valuation advice was provided by the office of the Chief Valuer, in advising the Minister, as trustee.

In entering into such an agreement, at today's worth, the customary owners are tying up their land for at least the next 60 years for a capital value that equates to approximately SAT\$90,000 per hectare plus potential employment opportunities. This may seem significant to a poor subsistence community, but will inevitably be a source of intergenerational discord. In real terms, if they had the modest capital available the customary owners would generate a far higher income and maintain full control over their land if they were to build and operate a small-scale *fale* development on a small section of beachfront, rather than leasing a larger area of their land to external developer.

In the Samoan example, there is no equity share provision in the lease, of the type that is now commonly adopted through experience in the Fiji tourism leases over customary land administered by NLTB, or through the conflict avoidance equity sharing such as in the example in the GPPOL palm oil venture recently initiated in Guadalcanal, Solomon Islands. The Fiji model allows for the payment of a ground rent plus an equity turnover share of (variously) 1½-3% of the tourism venture takings (albeit that this is difficult to verify, particularly in terms of offshore bookings and payments). The tourism turnover model, does however, provide a participatory arrangement whereby the custom owners have a stake in the success of the venture and a remuneration increase that is better than inflation.

## ■ Conclusion

On several levels, the Samoan example is likely to lead to infighting, political challenges (if the actions of the Trustee are challenged, which whilst not likely in the short term, given the chiefly nature of the Trustee, could inevitably be the cause of matai distrust and infighting in future years), particularly as the expiration of the second lease term approaches. The example, of course, provides a lease that appears to be too good to be true on the part of the tourism developers, given that they will realistically clear their development costs and be operating on pure profit by year 15. The reality is that deals that appear to be too good to be true usually are, and achieving a deal that does not provide a fully equitable return to customary owners in the long term will inevitably be a cause of future conflict and disruption to the business venture.

It is important to note that in the Fiji example the recommendation to move away from the limitations of the UCV model was mirrored in the actions of the Fiji Cabinet in July 2007, who have now taken steps to allow a market value approach to leases over customary land (Government of Fiji, 2007).

As with all land dealings, there are ramifications in any action. Whilst the action of the Fiji Government in supporting a market rental approach to leases over customary land is welcomed as a positive initiative, it is not yet clear how far they have thought through the implications – especially how the amendments to Native Land Trust Act legislation will play out when the 18,000 expiring residential leases are renegotiated. Will, for example, a market value approach be allowed to reflect the value of improvements on the land? Issues such as this, and more particularly the valuation methodologies to support the determination and application of market rental values, will have to be fully thought through with some haste to minimise tenant based reaction and potential conflict.

By illustrating some of the challenges and possible solutions to the financial management of customary land in the Pacific, this paper strives to support and protect Indigenous interests. Without clear education over property rights, the current examples highlight that there is a strong likelihood that naïve short term gains from leasehold structures could weaken or diminish Indigenous interests and rights over their customary land in the Pacific in the long term. However, carefully drafted leases that deal with improvements beneficially (from the custom owners perspective) do provide a workable intergenerational solution to the financial management of customary land whilst liberating access to those who strive to use the land for productive purposes (be it agricultural or urban investment).

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