Efforts and Errors: South Africa's Search to Extend Housing Finance to Low-Income Households

by Mary R. Tomlinson

BACKGROUND

South Africa's housing sector has spent the past seven years looking for ways to extend the delivery of housing finance to low-income households. Various lending instruments (mortgage lending and pension/provident-backed loans) have been tried; several housing finance institutions (both guarantor and wholesale)[1] have been established; and very many articles have appeared in the local press to try to locate blame for the supposed lack of housing finance.

This paper describes the trail followed in dogged pursuit of housing credit since the early 1990s. First, it will briefly describe the formulation of South Africa's new housing policy. It will explain the policy approach adopted by government intended to extend the delivery of housing credit to the low-income market, and will argue as to the incorrectness of this approach.

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The paper will describe what progress the financial sector has made during this period; often things accomplished were not what government expected but rather innovations coming from the sector itself. It will also describe some recent thinking by both the banks and government on a possible way forward.

Last, it will examine the relationships that have developed between various classes of lenders, both the formal banks and the newly emerging alternative lenders, and some of the consequences (cooperation and competition) of these relationships. The paper will then attempt to draw some conclusions as to what has occurred around the attempts to extend housing finance to low-income households; the tensions that may have arisen through these attempts; and some issues that still require addressing.

A BRIEF HISTORY OF SOUTH AFRICA'S HOUSING POLICY

As is commonly known, South Africa's housing policy arose from a unique process. In 1992, prior to the first democratic elections, a multi-party body the National Housing Forum (NHF) was established to formulate a consensus around a new non-racial housing policy.

Negotiations were characterized by fierce debates around, e.g., whether housing should be delivered by the market or by the state; if the standard provided should be a completed "four-roomed house" or "progressive"—i.e., incremental housing; how to attract financial institutions back into an embryonic housing market they had been forced out of, due to a wildly fluctuating economy and the threat of bond boycotts and so on.

The results of these debates, as reflected in the policy as it was adopted in the Housing White Paper (1994)—and which has barely been altered since that time—is a housing delivery approach whereby government "facilitates a framework in which the private sector carries out delivery." Key to the policy is the delivery of a once-off capital subsidy to all households with an income of less than R3,500 (US$350) per month. The largest amount of subsidy available (and which 90% of the qualifying households access) has recently been raised from R16,000 to R20,300 (a 26.8% rise)[2].

Generally the full subsidy provides a 30-square-meter structure, on a 200-square-meter serviced site. This is widely acknowledged as being insufficient to provide a "four-roomed house," as promised by the African National Congress politicians at the time of the 1994 elections. Hence, there was written into the policy a commitment by the financial sector to provide sufficient end-user finance to make the vision of a "four-roomed" house a reality.

Research, carried out since the policy was implemented, has revealed a number of lessons regarding many of the key policy decisions made at the NHF, and none more so than around the provision of housing finance.

LESSONS AROUND THE DELIVERY OF HOUSING FINANCE

A wildly fluctuating economy, in the late 1980s and early 1990s, which led to interest rate spikes that were simply unmanageable for first-time newly mortgaged black households was the first indication that lending to low-income people was not going to be easy.

In addition, the threat of politically inspired "bond boycotts," which were being used as a "weapon of the struggle," led to an almost blanket ceasing of the housing finance that the formal financial institutions (retail banks) had begun to make available to the emerging low-income housing market.

Financial institutions insisted that their participation was being constrained by their inability to re-possess a house when a homeowner defaulted on mortgage repayments. Often so-called civic leaders would organize the community to prevent evictions from taking place. Or, if an eviction did occur, communities would ensure that the houses were rapidly moved back into. Considerable efforts were therefore needed by government to turn around this "abnormal" lending environment[3].

Record of Understanding

A Record of Understanding (ROU) between the Department of Housing (DOH) and the (former) Association of Mortgage Lenders (AML)[4] was concluded in October 1994 following negotiations aimed at creating a "stable public environment" which would be conducive to the resumption and extension of lending to low-income borrowers, in particular subsidy beneficiaries.

The establishment of a Mortgage Indemnity Fund (MIF)—a three-year interim measure—was put in place to cover accredited lenders if they were unable, for political reasons, to repossess properties using the normal legal channels once default on a property had occurred. At that time, the financial institutions had 33,000 non-performing loans on their books, a figure which has since risen to approximately 54,000.[5]

Under the MIF cover, the financial institutions were expected to provide 50,000 mortgage loans to low-income borrowers in the first year of the three-year agreement, with 150,000 in total over the full three years.

As previously noted, the reason for this was because the new Housing Subsidy Scheme was formulated on the basis that, in addition to the housing subsidy from government, low-income households would also be able to access a mortgage bond that would then be used to purchase a conventional "four-roomed" house.

Looking back, it is clearly the case that at the time of signing the ROU and establishing the MIF, it was often remarked that there was far too much emphasis being placed on conventional mortgage bonds as the most appropriate form of credit for the low-income market.

By the time the ROU was signed there was already sufficient evidence of households having been "over-borrowed" when their economic circumstances worsened—because of retrenchments, spiking interest rates and so on. Nevertheless, mortgage lending is precisely the road government chose to go down in developing its new policy.

The Result of the Record of Understanding

Reviewing the MIF Closure Report covering the three years it was in operation reveals that it guaranteed more than 140,000 loans, valued at approximately R10 billion[6]. Of these, 73,000 (R4 billion) were granted to beneficiaries of the government's housing subsidy scheme (i.e., households earning less than R3,500 per month).

Tensions have arisen over interpretation of the ROU agreement. Government has persistently claimed that the goal of 150,000 loans over three years, or 50,000 annually, was to be aimed entirely at the subsidy market. Banks claim otherwise, and point to constraints in borrower's affordability as the primary reason households have not purchased housing using a mortgage bond. This standoff between the banks and government has, in effect, sterilized much of the housing finance debate in the country, making it difficult to have any reasonable discussion on housing finance issues.

The one thing that is not up for debate is the fact that once the government closed down the MIF and, in effect, removed its guarantee, lending for new low-income housing dropped considerably as the conditions[7] that had initially caused the formal banks to withdraw from lending to this market had not been addressed.

WAS THERE ANOTHER OPTION?

Looking back over this period, it is clear that there were other options. Over this same period both banks and emerging non-bank lenders (known at the time as alternative lenders[8]) were providing a new and different financing product known as "micro-loans." Mainly, between R1,500 and R20,000, these small loans are generally secured with a pension/provident fund benefit, rather than brick and mortar, and repaid through a payroll deduction facility. In cases where there has been no pension/provident fund facility, these loans have been unsecured, simply relying on payroll deduction and debit orders for repayment.

Micro-loans can be used for a variety of purposes, e.g., including purchasing building materials necessary to incrementally build onto the rudimentary structure the subsidy provides. While these small loans may not be sufficient to purchase (when combined with the subsidy) a four-roomed house, within a short period of time a subsidy house can significantly increase in size.

Observation of lending patterns quickly began to reveal that beneficiaries preferred these small loans that they could periodically take out and quickly pay off, rather than one large loan, mainly because they are better able to control their financial situation when exposed to economic shocks.

Suitable for Both Borrowers and Lenders

Besides the fact that these "micro-loans" quickly began to be recognized as being much more suitable to the needs of the low-income borrower, they have also turned out to be much more secure for the lender as well.

This is primarily because they are not tied to the security of the house. Hence, the lender is not placed in the difficult situation of needing to evict the borrower if he/she fails to pay the loan. More than likely the borrower will forfeit some benefit, in the case of pension/provident-backed loans to cover the outstanding loan amount if the borrower is unable to continue paying the loan. Where there is no pension/provident fund to act as security, the loans are priced to cover any outstanding debt if they go bad.

For banks, in particular, worried about issues such as return on equity (ROE)—the commercial logic that drives a bank[9]—this safer, more secure form of lending starts to make sense. Moreover, pension/provident-backed lending does not depend on costly, highly staffed branch banking networks. Rather it depends on the employer carrying out some of the time-consuming and costly functions traditionally carried out by the bank, e.g., originating the loan.

A similar tale of success can be seen with the micro-lenders doing unsecured lending. They too have found a way to do this type of lending profitably as long as they are able to price adequately for their risk[10]. Table 1 shows the current rates on different types of loans.

The recently established Micro Finance Regulatory Council (MFRC), which oversees the activities of lenders governed by the Usury Act, notes that, adjusting for leakage, in the 12 months ending August 31, 2000, between 360,000 and 880,000 micro-loans totalling between R2.6 billion and R6.3 billion were disbursed for housing purposes[11].

Table 1

Loan Type	*Size*	*Term*	*Rate*	*Collateral*
Mortgage bond	R80,000	20 year max	Prime –2 – +2% (variable)	House
Micro-loan (secured)	R10,000	3–5 years	Prime (variable)	Pension/ Provident fund
Micro-loan (unsecured)	R5,000	20 months	40% +	None

So while the national housing strategy may have rested on the twin pillars of a direct once-off capital subsidy by government, coupled with a mortgage bond from the banks, the fact is that less than 1% of the subsidy market has been linked to a mortgage bond (Department of Housing Statistics, April 2001).

At the same time an enormous number of households have accessed small micro-loans (both secured and unsecured) granted by both the retail banks and alternative (micro and niche market lenders), many of whom access wholesale finance from the National Housing Finance Corporation and the Rural Housing Loan Fund, two of the important housing finance development institutions set up to serve the alternative lender's needs.

NEW THINKING BY THE BANKS AND GOVERNMENT ON A POSSIBLE WAY FORWARD

A Banking Council Proposal

In fending off criticism by government about their lack of lending into the low-income housing market, a few years ago the banking industry began making a rather interesting proposal[12] as to a way forward on this issue. The banks rightly claim, as demonstrated above, that there are others, i.e., the alternative lenders, who are much more appropriately suited to interfacing with low-income borrowers. The argument follows, that rather than forcing the banks to lend in a market where they are uncomfortable, rather they should find ways to support entities able to more satisfactorily do this type of lending.

Banks, it was suggested, rather than providing the traditional services of, e.g., mortgage origination and servicing of loans, would provide the liquidity required by entities that have begun to claim this market as their own, but have run into liquidity constraints due to them being seen as less secure investment vehicles than the formal banks[13]. A few of the big banks have therefore attempted developing arrangements based on using brokers to originate loans and micro lending partners to collect the loans.

A Government Proposal

During this same period government has been looking for ways to redress the discriminatory practices that it believes the financial sector engaged in during the apartheid years—and claims may still be engaging in today. Looking to the United States as a model, the South African government has been pursuing the passage of a package of legislation similar to the U.S. Community Reinvestment Act.

More specifically, two pieces of legislation have recently been passed, i.e., the Promotion of Equality and Prevention of Unfair Discrimination Act 2000 (similar to the U.S. Fair Housing Act) and the Home Loan and Mortgage Disclosure Act 2000 (similar to the U.S. Home Mortgage Disclosure Act).

As background to this legislation, it has been fairly apparent that how much lending the formal retail banks do in the low-income market has been anybody's guess.

The main reason for requiring the banks to disclose their lending figures is that it will allow government to determine which banks are lending, how much lending they are doing and where it is located. Following on an analysis of the data it is intended that through the (expected) passage of the S.A. Community Reinvestment (Housing) Bill 2002 the banks will be compelled to meet certain targets of lending set down by government.

The South African banking sector has risen to this legal challenge with arguments claiming the government is compelling them to carry out unsound lending (their words), which will shake overseas investor confidence. A careful reading of the bill, however, reveals that the application of the bill is actually rather innovative.

Rather than compelling the banks to carry out explicitly directed locational lending into areas they clearly want to avoid due to their risk profile, the legislation offers a variety of options for the banks to choose from in meeting the targets set down by government, including:

- Providing funding through a prescribed wholesaler (presumably the NHFC) at a mutually agreed interest rate for on-lending.
- Purchasing such wholesale lender's securities and debt instruments.
- Providing funding directly to alternative lenders to on-lend.

In principle, does this approach not sound somewhat similar to the Banking Council proposal? The housing sector is already beginning to see much fur flying around CRA as government and the banks argue it out in the local press.

COMPETITION OR COOPERATION?

What relationship has grown up between the banks and the alternative lenders?

Looking back over the development of the housing finance sector throughout the 1990s, it is entirely appropriate to begin examining the new terrain that has developed between the banks and the alternative lenders. (See Rust, 2002 for a full discussion of this issue.)

Moreover, it is worth asking the question: "Through government continually pressuring the banks to go downmarket does this not in fact end up promoting an environment of competition between the formal banks and the emerging alternative lending sector that everyone is keen to see become established?"

In examining the development of the low-income housing finance sector a number of points of "competition" that have arisen between banks and alternative lenders, for example, in product range, collection methods, pricing and so on, are clearly revealed. These points will be addressed below.

Product Range

Whether originated by a big bank or a small alternative lender, loans secured by pension/provident funds are viewed as the most attractive instrument to use in the low-income market. This is because these loans are highly secure, are larger and more profitable than the smaller micro-loans, and can be extended to a large group of borrowers on a once-off basis through a single employer.

Unfortunately, for the emerging alternative lenders, big banks are viewed as having a larger asset base; therefore they are viewed as the more secure institution from which to source pension/provident-backed loans.

This view has certainly been reinforced this past year when a number of South Africa's smaller banks and micro-lenders went under due to their supposed liquidity crises. In looking back over this experience, it seems there were, in fact, a variety of factors that caused these lenders to fail, including the perception of risk, poor governance, poor collection methodologies, as well as the lack of liquidity.

Competition Around Disbursement Mechanisms

Government regulators have been keen to promote investment (housing/education) lending rather than consumption lending in the society. One of the ways lenders[14] manage the leakage (away from housing) notable in the low-income market is through their disbursement mechanism.

Some lenders provide loans for housing purposes via cash or direct transfer. Other lenders prefer consumer credit, which demands that the loan is paid out via a third party, e.g., a supplier of building materials and is therefore certain to be used for housing purposes.

A degree of competition has therefore arisen in cases where big banks partner with an alternative lender. Such a partnership can provide the micro-lender with an ability to pursue relationships with, e.g., building suppliers, more aggressively than the micro-lender operating on its own.

Collection Methods

The recent experience of several of the small banks, and/or alternative lenders acting in partnership with big banks, going under has put a new focus on collection methodologies.

Collection methods range from the least secure, i.e., direct cash, through to the very secure, i.e., debit orders and payroll deduction. The big banks only operate in the segment of the market that is formally employed; therefore they only use the payroll deduction facility, which is well known for its ease of administration and limited losses.

The alternative lenders are left with the clients that need debit arrangements, or sometimes cash repayment facilities. Moreover, debit orders can be broken down into "preferred" and standard debit orders.

The debit order system operates through an agreement between a formal bank and an alternative lender. That is, the bank agrees to make payment directly to the lender from the client's account. Obviously a "preferred" debit order means that a particular claim will be honored before any other claim. In the case of the standard debit order there is no preference for claims, making it far less attractive to the lender.

Because the regulatory environment in which the financial sector operates ensures that banks are the only institutions able to accept deposits, they are able to use this requirement to their own advantage. Alternative lenders end up competing amongst themselves to derive this "preferred" status.

This is the main reason the alternative lending sector has proposed exploring ways of setting up preferred debit orders on customer's account using non-bank lenders. Noteworthy is the fact that the banks control the country's payment system, Bankserve. Without real pressure from government to end its monopoly, the banks will be slow to act on such a proposal.

As mentioned previously, direct cash collections are considered the most costly and least secure repayment method for lenders to handle; they can often rely on rather unsavory methods to ensure repayment. Based on personal relationships, they require that the large transaction costs involved need to be recovered in the price of the loan. As banks do not engage in this form of collection, it is left to the alternative lenders to struggle with successfully delivering these types of loans profitably.

Pricing

The pricing of loans is highly competitive. As previously stated, banks only deal in secure loans, i.e., where the interest rate necessary to make them profitable can be charged. This leaves the alternative lenders to operate in the unsecured segment of the market where the interest rates that may be charged may not be sufficient to cover the cost of pricing the risk of the loan.

The Usury Act Exemption Notice, which mainly applies to the alternative lenders, specifies that only loans of less than R10,000 (US$1000)[15] may be priced fully for the risk incurred. Loans above R10,000 find they have an interest rate ceiling to contend with.

Several things have resulted from this regulation. First, loans for more than R10,000 (up to R80,000) are pretty much unavailable. Second, lenders operating below R10,000 need to work towards developing economies of scale if they are to see any profit in what they are doing. But, once alternative lenders begin to reach economies of scale in their business they invariably hit a liquidity ceiling.

The result is that alternative lenders are unable to grow their lending books beyond being able to make many small costly loans, rather than fewer big and cheaper loans necessary to sustain their business.

CONCLUSIONS

There are three significant players in South Africa's low-income housing market: the banks (both big and, until recently, small); alternative lenders that have arisen since the early 1990s, including micro lenders and focused niche market housing lenders; and, in addition, a relatively recent phenomenon has been the growth of arrangements between big banks and alternative lenders.

During the period of expansion of the housing finance sector, it is clearly the case that the playing field on which all of these lenders operate, has been far from level. The emerging alternative sector finds itself competing with the formal banks in terms of systems, processes, and regulatory structures. At the same time, government continues to pressure the formal banks to move downmarket and operate in the space carved out by the alternative lenders, setting up endless points of competition between the two.

It is therefore ironic that, on the one hand, government continually calls for the development of an alternative housing finance lending sector. On the other hand, through the constant pressure (verbal and legislative) government exerts on the banks to go downmarket, it would appear to be acting contrary to this end.

NOTES

[1] The key housing finance institutions are the National Housing Finance Corporation (NHFC), the Home Loan Guarantee Company (HLGC), NURCHA and the Rural Housing Loan Fund (RHLF). These institutions are described at the end of the paper.

[2] In 1994, the amount of the subsidy was R12,500 for the lowest income group.

[3] Today this situation is characterized as the "housing swamp"—in other words there are key factors contributing to this perceived risk, including: increasing poverty and unemployment; a lack of education and a poor understanding of housing issues among first-time home loan borrowers; structural defects in the housing being delivered; irresponsible community leadership urging non-payment; breakdown in law and order; and deteriorating environmental conditions due to local authorities abrogating their responsibilities.

[4] The Banking Council, SA has replaced the AML, as the voice of the banking industry. The formal banking sector involves deposit-taking institutions (banks and small banks), which are governed by the Banks Act, 1990. Mutual banks are governed by the Mutual Banks Act.

[5] Discussion with D. Creighton, MD Servcon Housing Solutions, June 26, 2002.

[6] The total number of loans on the banks' mortgage books in the low-income market is approximately 300,000.

[7] In recent years the "risk" problems have been characterized as the "housing swamp." In other words, there are key factors contributing to this perceived risk, including: increasing poverty and unemployment; a lack of education and poor understanding of housing issues among first-time borrowers; structural defects in the housing being delivered; irresponsible community leadership urging non-payment; breakdown in law and order; and deteriorating environmental conditions due to local authorities abrogating on their responsibilities.

[8] Alternative lenders began to be established in the late 1980s. They include micro-lenders, niche market (housing specific) lenders, and NGO lenders, all of which are considered to be non-deposit takers, making them regulated by the Usury Act, rather than the Banks Act. The Usury Act sets limits on interest rates that can be charged. Through the Usury Act Exemption Notice, loans of less than R10,000, repayable over 36 months and offered by registered micro-lenders, are exempt from this cap.

[9] South Africa ascribes to the principles of the Basel Accord, which requires a certain percentage of the assets of the bank to be held in the form of capital. In addition, banks must hold cash reserves against their deposit-taking activities. The result is that much of a bank's capital is tied up around its retail activities—mortgage lending in particular. The trend worldwide is to see lower ROE's on retail banking activity, making it one of the less attractive activities for a bank to pursue—see R S K Tucker, The Retail Dimension, The Banking Council, SA, October 1999.

[10] The Usury Act, rather than the Banks Act, regulates non-deposit taking micro-lenders. The Usury Act sets limits on the interest rates that can be charged. Through the Usury Act Exemption Notice, loans of less than R10,000, repayable over 36 months, and offered by a micro-lender registered with the Micro Finance Regulatory Council, are exempt from this cap.

[11] Figures supplied to Kecia Rust by Gabriel Davel, MFRC, January 24, 2002.

[12] At a Housing Seminar hosted by the DOH in 1999, the Banking Council, SA made this proposal.

[13] Over the past few years there have been several examples of banks and micro lenders partnering, e.g., Standard Bank and African Bank, and until recently, ABSA Bank and Unibank.

[14] Noteworthy is the fact that any lender receiving wholesale funds from the NHFC or the RHLF should use them for housing purposes.

15 Banks making loans of R10,000 are also able to operate within the Usury Act Exemption.

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KEY ORGANIZATIONS REFERRED TO IN THIS TEXT

- *Home Loan Guarantee Company*—A section 21 (not-for-profit) company that facilitates access to housing finance by providing, mobilizing and managing guarantees to institutions making funds available for affordable housing.
- *National Housing Finance Corporation*—Established by the state in 1995 as a development finance institution aimed at seeking ways to mobilize housing finance for the low- and moderate-income market, primarily by acting as a wholesale financier.
- *National Urban Reconstruction and Housing Agency*—A section 21 (not-for-profit) agency that facilitates low-income housing by guaranteeing loans made by commercial banks and other lenders.
- *Rural Housing Loan Fund*—Established in 1996 as a section 21 (not-for-profit) wholesale lending institution that operates with a social venture capital mindset to create new financial arrangements and opportunities for rural families to improve their housing, economic and living environment.