Challenges in Mortgage Lending for the Under Served in South Africa

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Introduction

Expanding access to finance can play a very important role in reducing poverty among underserved communities. Among other things access to finance can facilitate income-generating opportunities. The poor can also take advantage to build capital and improve their living conditions, especially if they are homeowners. This is because homeowners are able to accumulate wealth as the investment in their homes grows and they enjoy better living conditions. Unfortunately, financial exclusion is a common phenomenon in most developing parts of the world, in particular sub-Sahara Africa. In most cases access to finance is inhibited by lack of well-developed financial system, inadequate infrastructure, limited products, or affordability problems.

Despite South Africa's relatively sophisticated financial system compared to other countries in sub-Sahara Africa, it appears the housing finance system has not been able to replicate for the low to moderate income families a system that allows for their access to adequate formal housing finance. Current challenges to mortgage lending and borrowing in South Africa cannot be overemphasised. The issue of affordability is a major constraint, but limited end-user finance has also greatly restricted the level of effective housing demand especially in the low-income housing market. While evidence shows that many people are willing to pay the market interest rate most are unable to access funds. For instance, a study of the informal credit market in South Africa indicates that households seeking credit simply could not get hold of finance except through the informal moneylenders and pawnbrokers at very high interest rates of about 20 per cent a month or more. Unsecured loans are often provided by alternate lenders to low-income borrowers at risk-based rates of up to 43 per cent per annum, which exceeds market interest rates often by several times. These experiences suggest that it is perhaps access to credit rather than an affordability problem, which is the main obstacle for housing finance for significant groups in the case of South Africa.

However, there are other issues relating to governance that inhibit lending to low income people in South Africa. There has been a politically motivated mortgage repayment boycott in the past, and currently there are instances where banks are unable to repossess property in the event of default in certain areas and banks find it difficult to use courts to resolve the issues. For example, evidence from the First National Bank show that some areas in KZN province, townships had literally been divided into factions so that certain potential borrowers are unable to purchase houses in areas of their choice because they are not affiliated to the faction popular in the area. Also the bank stopped lending to low income borrowers in some communities because it was difficult repossessing on defaulted properties belonging to certain eminent faction leaders in the area. Further more, there are instances where borrowers stopped paying their mortgages because of infrastructure breakdown in the area. Thus, lenders are reluctant to lend for purchases in such areas because of potential loses associated with defaults, and also because intermittent service and infrastructure breakdown diminish property values in the area.

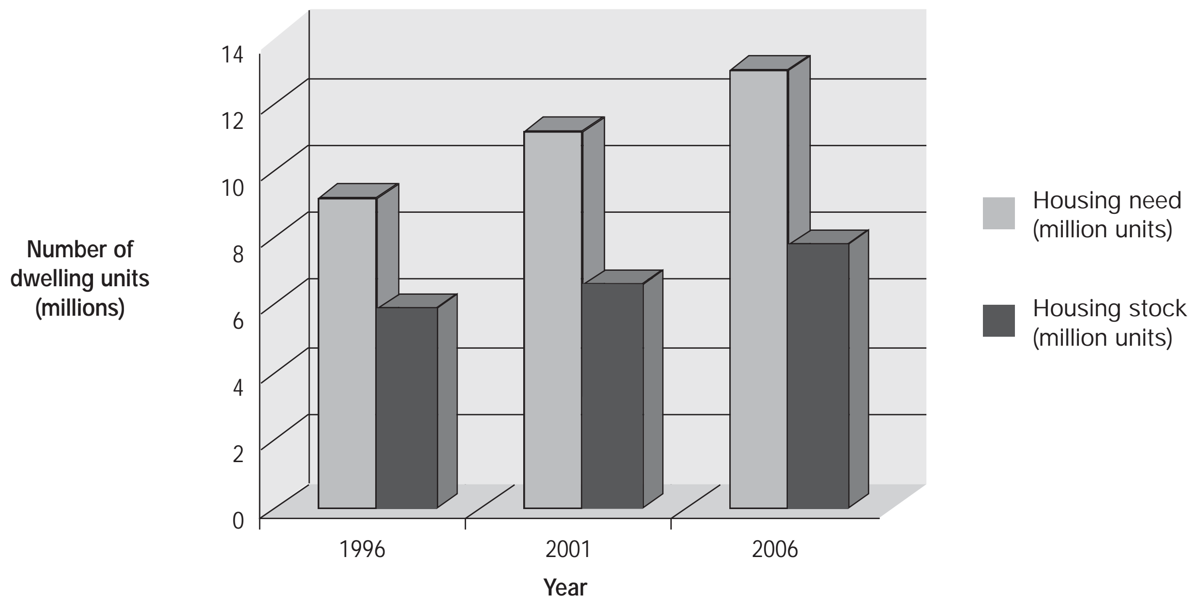
South Africa is about to sign off on a Financial Services Transformation Charter that will commit the banks to substantial lending to low income people for housing. But risk associated to lending to the lower end of the market as the above example has illustrated requires partnership with government so that risk is appropriately shared and mitigated. In this article we present further empirical findings on impediments to institutional lending and household's predicaments in borrowing in the context of a case study of Durban and Umlazi in KwaZulu-Natal Province of South Africa. We identify the major constraints and pointed out what needs to be done to improve institutional mortgage lending and borrowing by the under-served urban market. As a prelude to the analysis, the paper provides an overview of the current situation in South Africa with regard to demography, dwelling stock and needs and nature of finance.

The current situation in South Africa

Demography

With a rapidly increasing and urbanising society, South Africa's population of 40.6 million in 1996 increased to 44.8 million by 2001 (SSA 2001), and projected to 49.8 million by 2006. The number of households in 1996 was estimated as 9.2 million, 11.2 million in 2001 and projected to 13.1 million by 2006. However, given the rate of HIV/AIDS infection and deaths related to the disease in South Africa, the above population projections may not reflect the situation on the ground in the next 5 to 10 years. According to Hacker (2002), about 19.9 per cent of adult population in South Africa were HIV positive in 2000. The high

Chart 1: Estimates of Dwelling Stock and needs in South Africa (1996–2006)



Source: Own calculations based on 1996 and 2001 data from Statistics South Africa website.

rate of HIV/AIDS related deaths implies the rate of population growth could decrease by between 0.6 and 1.5 per cent by 2005, and 3 per cent by 2010. There is substantial uncertainty about effect of HIV/AIDS on population growth and demographic trend in general. The implications on housing demand and finance provision in South Africa cannot be overemphasised. But these issues are beyond the scope of this paper and would not be discussed.

Dwelling stock and need

Taking the size of housing need as the equivalence of total number of households, South Africa's housing need of approximately 9.2 million units in 1996, is projected to 13.1 million in 2006. The total housing stock consists of formal and informal housing. From an estimated level of 5.9 million units in 1996, it is estimated that the housing stock would be 7.9 million units by the year 2006. We define housing backlog in simply terms as the difference between the housing need (effectively, the number of households) and the total housing stock at a time. Clearly, Chart 1 shows a mismatch between housing stock and housing need, which represents the housing backlog. The housing backlog of about 3.3 million units in 1996 would increase to about 5.2 million units in 2006. The consequence of housing backlog is physically reflected in overcrowding and prevalence of squatter and backyard buildings especially around urban areas. The scale of the housing backlog and the rapid growth in housing need presents many challenges to all aspects of the housing market - demand and supply.

Housing finance

Generally, lending institutions in South Africa consider gross income of less than R3,500 per month (at 2001 rate of £1~R12) as inadequate to support a basic mortgage loan. However, there are numerous housing loan initiatives as presented in Table 1, and products for income groups R1,500 to R7,500 are currently being considered. But the proportion of working households earning gross income of R3,500 per month or more in South Africa is only about 20 per cent. Households unable to access institutional loans consist of those deriving incomes mainly from informal sector. Approximately 45 per cent of these households earn gross income of less than R2500 per month, about 25 per cent earn between R2,500 and R3,500 per month, and about 20 per cent earn R3,500 or more. Currently about 70 per cent of households in urban South Africa are not able to access institutional finance. New evidence from Moss and Pillay (2000) suggests that among households unable to access institutional finance, 41 per cent were not provided with mortgage loans mainly because of their low incomes and about 30 per cent were unable to access credit because they were informally or self-employed. Also, 29 per cent could not access credit partly because of over-indebtedness. In most urban areas, low and moderate-income households are self-employed, and their incomes vary greatly and can be infrequent. This results in a lack of interest by commercial financial institutions to lend to this market.

Table 1: Types of housing loans in South Africa and their attributes

Loan characteristics/ Loan type	Main purpose of loan	Requirements and terms	Loan size and subsidy eligibility
Conventional loan	– Provided by banks and other major lenders for purchase of formal houses up to 80% LTV.	– Mainly offered to those earning above R3500 per month; – First lien on house; – 20% down payment or employer guaranteed; – Self amortisation over 20-30 year – Mainly variable interest rate between 14 and 15%. – Foreclose on default.	– More than R50,000 loan; – Borrower not eligible for government subsidy.
Affordable loan	– Provided by banks and alternate lenders to bridge gaps between what a household earns, deposit and monthly repayments. – Up to 100% LTV.	– Borrower must usually earn R2500 or more, but lower Income may qualify; – Pledge provident or pension; – Employer guarantee; – 20 years term; – Variable and fixed interest rate; – Up to 35% household payment-income ratio; – Foreclose on default.	– Up to R50,000 loan; – Could get government up front subsidy up to R23,100 (depending on income).
Non-mortgage loans	– Mainly offered by small banks and micro lenders for incremental house building.	– Generally for low-income earners in formal employment; – Pledge of provident fund, payroll deducted; – 2-5 years term at risk based pricing 13% above traditional; – Provident fund taken on default.	– Up to R20,000 loan; – Could get up to R23,100 government subsidy (depending on income).
Individual unsecured loans for the informally employed	– Usually offered by alternate and micro lenders to informally employed to build their houses.	– For very low earners; – Very short term (cash loan of 1-3 months); – Risk based pricing/up to 40 per cent over conventional loans; – Defaulter denied further loan.	– Usually very small loan (<R6,000); – Could get up to R23,100 in subsidy.
Unsecured micro loans and grants for informally employed from NGO's	– Usually grant or soft loan from benevolent organisations to vulnerable or needy people to provide housing requirements – May be group based.	– Recipient must qualify according to donor means test and policy and eligible for government subsidy – Recipient enthusiasm to commit labour to programme; – Small interest rate may apply; – Defaulter denied further loan.	– Amount varies from donor to donor and according to recipient situation; – May be eligible for government subsidy up to R23,100.

The Durban-Umlazi study

This is an exploratory study of mortgage lenders in Durban and borrowers in Umlazi Township, which is part of Durban Metropolis in the KwaZulu-Natal Province of South Africa. It must be pointed out that the findings presented relate more to sub urban housing and its financing. Housing finance in rural South Africa could well be different. The study involved a sample of 198 households made up of key workers in the public sector, including teachers, civil servants and police personnel selected from Umlazi, an area occupied by blacks, and the main five mortgage lenders in Durban: ABSA Bank; First National Bank; Natal Building Society; Standard Bank of South Africa; and Nedcor Group. The findings are based on a sample of households. The target household is the one that seemed to have adequate income but found it difficult to enter the formal housing market because of the lack of access to private institutional finance. We focused on public sector employees because, a priori, they appear to offer better security and less risk because of relative job security and government assistance, yet many seemed not to be getting access to institutional finance. Private sector employees and the self-employed might behave differently when attempting to access institutional finance because unlike public employees, their jobs may not be secure and they may have limited or no employer assistance.

The Evidence

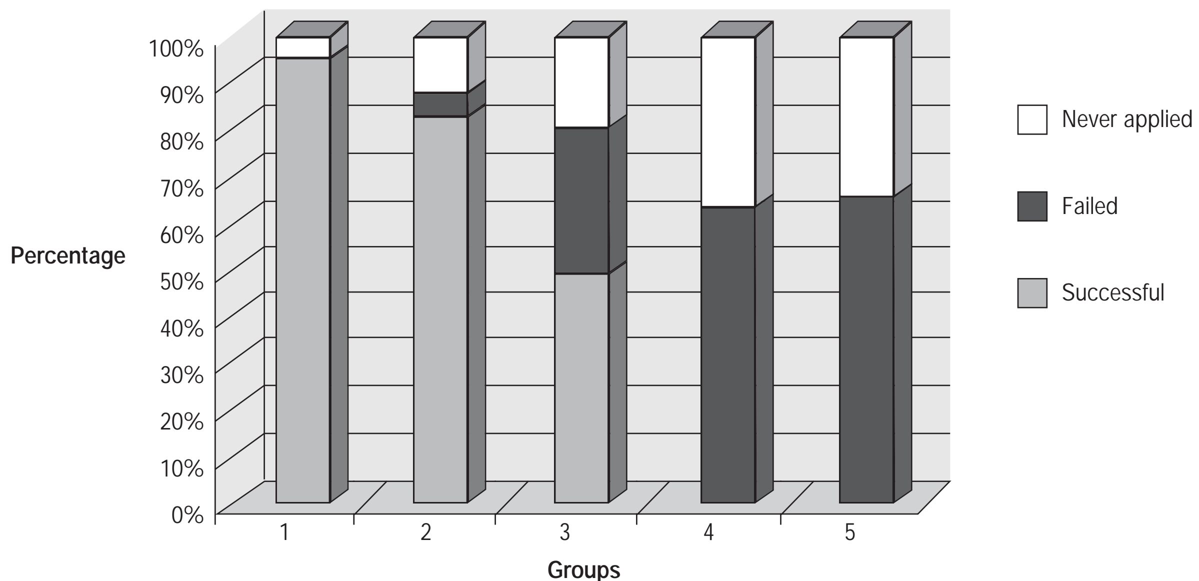
Data and analysis

The basic criteria for lending that lenders generally establish are that certain basic requirements are met. Thus, the potential borrower must pass the five C's (Character, Capacity, Capital, Collateral and Conditions) assessment test. In simple terms this means an attempt is made to establish that the potential borrower is a person of good character who will pay back the loan; has capacity to pay; demonstrate capital and wealth to have a financial stake in the property; show evidence of collateral security; and be able to honour the mortgage agreement in all conditions under the terms.

Households in the study are classified into five groups as shown in Chart 2 and analysed according to three categories based on whether or not they have applied for mortgage loan and the outcome. Each group is identified by attributes that determine level of affordability and/or accessibility applied by the various institutional lenders, which include income/employment requirement, savings and deposit, collateral requirements, credit record, family size, other credit commitments and level of subsidies and employer support. Based on these conditions affordability ranges highest from group 1 down to the lowest in group 5. However, it must be noted that, although we have classified respondents into five groups, there is no sharp demarcation between the groups; rather, there existed certain overlapping elements.

From Chart 2 the proportion of successful mortgage applications decreases as one moves to the right from group 1, an indication that lenders perceive higher probability of default as income decreases and/or when other requirements are not fully met. The proportion of Failed applications also decreased as one moves from group 5 to the left, confirming lenders consistent lending criteria. Detailed analysis of the data suggests households with multiple earnings gained significant access to institutional finance. Although households in groups 1 to

Chart 2: Group classification by outcome of mortgage application (n=198)



3 met the income requirement, about 30 per cent in group 3 and 4 per cent in group 2 were denied loans because their income derived from informal sources were not considered by lenders in determining access to finance.

All successful applicants indicated that they obtained employer support in the form of down payment (deposit guarantees). Although many respondents were observed to have household sizes greater than the average, the data show that some of such respondents were successful in accessing institutional finance. Thus, it suggests that a large family size per se, does not inhibit access to institutional finance, especially where incomes are relatively high. Many successful respondents felt they were granted mortgage loans by banks because of government interventions, such as the provision of guarantees and the introduction of mortgage indemnity, which encouraged lending to areas previously perceived as posing risk to lenders. In particular, few respondents indicated that in the past they could not access mortgage credit although their income was similar to their colleagues of other racial groups who had been granted institutional mortgage loans.

Detailed examination of the data show that many of those denied loans had larger families. This is probably because they couldn't provide enough evidence of financial security to the lender in view of their financial needs (large households) and capabilities (low incomes). However, most of them derived additional income from informal sources, could provide additional income security for institutional loans. But the banks do not consider informal income in evaluating affordability. Some of those denied mortgage loans indicated that they were victims of circumstances. That is, in spite of their high incomes, their creditworthiness was affected because banks did not have adequate records and information to evaluate their applications properly. Some of the failed applicants also indicated that they had wanted to use their land as collateral for the bank loans, but lenders were reluctant to accept it because most of the land is communally owned and did not have well-defined freehold titles, which were required by lenders as security for mortgage loans.

From the survey, about 95 per cent expressed interest in becoming homeowners, yet nearly a fifth never applied for mortgage loans. Among those who never-applied, over 70 per cent are between 22 and 39 years, which is the age group that institutional lenders are comfortable to offer loans. The data further show that the income (from all sources) of most of those who did not apply was sufficient to pay the minimum monthly instalment required by lenders. Thus, most are potentially capable of accessing institutional finance. The problem, however, is that lenders do not consider incomes from informal sources as viable. Furthermore, due to the lack of knowledge many had never applied for loan. They had learnt from people that banks provide mortgage loans to only rich and mainly to white people.

In a nutshell, while lenders aim to run low cost and low risk business in order to survive in the market, borrowers tend to believe that they are not provided the needed assistance to achieve their housing needs. From above analyses lenders and borrowers perspectives can be summarised as follows:

Lenders perspective

- Character: that many potential borrowers are unaccustomed to formal credit and financial obligations. Thus, they have no credit record for proper assessment;
- Capacity: that most have low and informal incomes, and in relation to price of dwelling it implies high default rate and insecurity for mortgage loan;
- Capital: that there is general lack of savings to fulfil the initial deposit requirement;
- Collateral: that prevalence of slums and backyard houses posed collateral risk;
- Conditions: that macroeconomic volatility creates cash flow and inflation risk and limits long-term lending especially to low income borrowers and that the transaction cost of lending for low income is uneconomical.

Borrowers' perspective

- Households seeking credit simply can not get hold of formal finance except through the informal moneylenders and pawnbrokers at very high interest rates;
- Household income is underestimated because income from informal sources (though often quite substantial) are excluded from mortgage evaluation process;
- Household ability is further underestimated because while estimating household expenditure estimates lenders include total expenditure relating to all members of the family, the income does not take account of incomes contributed by all members of the household;
- Inadequate borrower records and a rigid evaluation process makes it appear as though low-income and unsophisticated applicants are not creditworthy; and
- Many people are not aware of the implications and conditions of mortgage loan or fully understood the concept of homeownership through debt.

In order to ensure that institutions provide the needed funds affordable to borrowers it is imperative that these divergent requirements are reconciled.

Reconciling the divergent requirements: Policy suggestions

The issues emerging from the study shows perception of risks and costs associated with lending especially to low income people can lead to financial exclusion. Given volatility in employment, affordability problems, and the complexity of the conventional mortgage product, it would appear that the conventional mortgage instrument is not appropriate for low income people and that some of the non-conventional housing loan initiatives

presented earlier in Table 1 could be more appropriate for lower income people. However, if conventional mortgages are desirable, and given the divergent requirements, perhaps programs that can reduce lending risk can assure lenders that informal and low incomes are viable and can sustain mortgage repayment. Government could deal with the conditions, which affect access to finance but the role of lending institutions cannot be overemphasised. Policy makers need to consider carefully deficiencies in the market place, and the potential and limits of market-driven needs of lending institutions.

Lenders in the study area exclude formal incomes from the mortgage evaluation process in part because they believe that incomes pooled through informal sources are irregular and unreliable. Moreover, most informal businesses are not legal entities; therefore lenders are reluctant to accept the proceeds in legal mortgage contracts, as they perceived the related credit risk to be high. Most individuals derived much of their incomes from informal sources, but they are reluctant to register their businesses because of tax requirements. Financial institutions would be persuaded to believe that informal incomes are viable if they can be assured that such incomes would reliably provide adequate security for the loan. One approach for government might be to allow micro enterprises to operate without tax obligations, at least for some time, which would encourage the recognition of such incomes as formal, making them more acceptable by lenders. This will make a significant improvement to affordability for many potential borrowers and also improve the working of the informal business credit market. Contributions from extended family members are not considered in determining household affordability. But in an environment where extended families are common, such earnings constitute a significant part of household income. Thus, acceptance of such earnings would enhance affordability. This could be made possible if legislation allows such family property to be available for foreclosure when necessary.

We pointed out earlier that governance and other non-commercial reasons which inhibit housing finance needed attention. Although for South Africa as a whole, less than 5% of subsidised houses are credit linked, evidence from the case study area shows that government guarantees helped in attracting the private sector funding for many house purchasers. Thus, given that many potential borrowers have inadequate incomes to fulfil the down payment (deposit) requirement, it would be a worthwhile effort for government and/or employers to develop guarantees for such households. But such programmes should separate beneficiary groups facing different challenges in accessing finance and develop different interventions for each. This should be guided by principles of efficiency. That is, it should aim at achieving lowest cost per beneficiary and maximise beneficiary contribution to avoid replacing the expenditures recipient would make anyway. Such initiatives could encourage beneficiaries to contribute from own sources by for example, making own savings a criterion to qualify for a subsidy.

The absence of adequate information and records on potential borrowers had been a major impediment for the mortgage evaluation process and therefore the expansion of institutional finance. Investing in a mortgage asset requires that borrowers understand much the same information that the lender must understand. The lender requires understanding about the attributes of the property that serves as collateral and the market in which it resides, since the collateral will be received as security in the event the borrower defaults. The lender also needs sufficient information about the ability and willingness of the borrower to repay the loans in order to form expectations regarding risk and profitability of the investment. It is therefore important to develop an infrastructure for the collection, standardisation and dissemination of household and property data, for the benefit of participants in the mortgage market. The benefits of standardisation of data collection and dissemination, or at least the promotion of it, are clear. As available data increases in accuracy, quantity and activity or market coverage, there would be a corresponding increase in understanding of the functioning of supply and demand factors as well as of risk. As risk is better understood, it can be either eliminated or better managed. This has a direct implication for cost reduction, improves the inflow of capital, increases the availability of products and improves the prospects of homebuyers and market participants through lower costs and greater availability. Given the different levels of data and the capital required for development of such an infrastructure, specialised institutions (both private and public) must be mandated to collect such data. Perhaps government direct participation in such venture would be necessary.

The absence of adequate and credible information and records to properly assess affordability and credit risk imply that lenders could be taking significant risk, which is reflected in their styles of lending. It is therefore may be necessary to introduce an insurance or guarantee scheme (particularly from government) to help mitigate the risk associated with lending to households in the study area. Developing insurance/guarantee schemes, particularly for the self-employed, or informal earners and low-income borrowings, might be one approach to reducing the risk perceived by lenders. The basic argument here is that the guarantee, especially by government, might be 'cheap' and could help households nowhere near the margin. Insurance is critical to mortgage development and the needs of the real estate market in the study area are considerable, covering unemployment and death as well as political and investment risk. The primary issues for development of insurance programmes include developing data for actuarial assessment and developing markets. Significant health data could be gathered from the government. Some western insurers are already in South Africa, but their activities are limited to the upper part of the market. This could be expanded to other segments of the housing market with government providing credible support. Credible government guarantees can greatly reduce the risk of default. In general,

if the guarantee is not acceptable to the lending institutions for any reason, the housing debt will not be and no private institution would be willing to provide funds required for house purchases.

The problem of accessibility, as revealed by the study suggests that inadequate property rights militate against the desire to expand institutional finance. Moreover, slums and backyard houses that pose risk to the property sales prospects are prevalent in the study area. If a clear policy on land title were established, it would help to ensure that private property rights are recognised. This would generate a significant improvement in accessibility of institutional finance because lenders would be assured that the property had legal title. Also landowners could borrow from banks by using their own land as collateral securities for the loan.

Finally, given relatively low levels of knowledge with respect to housing finance in the study area, borrower education and counselling should almost certainly be an essential part of mortgage finance process. A homebuyer programme might be established by institutions to help educate and counsel potential homebuyers who intend to borrower from lenders. The approach could be supported by government, which appears to have great confidence among the people so that they may accept it. This programme could work in different ways, particularly through one-to-one with a professional credit representative who could help resolve credit issues. Potential borrowers could be helped to establish saving plans and budget for deposits or connected with down payment assistance programmes. The programme could also aim to educate, guide and prepare potential homebuyers for the responsibilities of owning a home. The benefits of such a scheme are the expansion of home ownership opportunities and the provision of financing solutions for those who couldn't afford it. This could help make the dream of home ownership a reality for many more people.

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