South Africa's Financial Sector Charter: Where From, Where To?

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INTRODUCTION

Key to delivering an acceptable standard of housing to South Africa's low-income households – income less than R3,500/USD $580 per month – has been the need for affordable housing finance. For over fifteen years, in response to this need, various means to extend the delivery of housing finance have been pursued[1]. Housing finance institutions[2], one providing risk-mitigation, two acting as guarantors and two acting as wholesale funders, were established as a means of encouraging lenders into the low-income housing market. In addition, various lending instruments (eg mortgage loans, pension/provident-backed micro-loans, unsecured micro-loans and savings-linked-to-credit) have been offered by a variety of banks and non-bank 'alternative' lenders. Notwithstanding the above, the results in the case of the formal retail lender have never met expectations.

This paper briefly describes some of the problems and tensions that arose between the banks and the government during this period. It examines the response of government to its frustration with the low level of bank lending and how it embarked, in the past few years, on an attempt to compel banks to lend through the introduction of community reinvestment-type (CRA) legislation. It describes the response of the banks to such a move and their decision to embark on a Financial Sector Charter (FSC) process aimed at transforming the entire financial sector, including increasing investment and the extension of lending, into the low-income housing market. The paper describes how this new thinking aligns with government's recently restructured housing policy. Last, some of government's key themes in its new policy will be described as well as the financial proposals arising from the process.

The effect of this FSC process has been, for the time being, to sideline the CRA legislation government had in the pipeline as a means of compelling banks to lend to low-income households. Rather government and the financial sector have embraced a new approach where they have agreed to stop bickering as to whose fault the lack of lending is and to rather accept the realities of the low-income market and then work out realistic proposals to deal with its higher than normal risk profile. This paper will describe this process and attempt to draw some conclusions about this new partnership aimed at tackling the on-going problems around a lack of appropriate housing finance.

A BRIEF RE-CAP OF THE HOUSING POLICY

South Africa's housing policy was formulated, during 1992 and 1993, through a negotiated process that involved vigorous debates over, eg the standard of housing that should be provided ('four-roomed house' or 'progressive' – ie incremental housing) and how to attract financial institutions back into the embryonic black housing market that they had fled from during the late 1980s[3]. The financial institutions' flight was mainly due to a wildly fluctuating economy, which resulted in interest rate spikes that were simply unmanageable for first-time, newly mortgaged black homebuyers. In addition, the threat of politically inspired bond boycotts, which had become a weapon of the 'struggle' against apartheid, were making it difficult for banks to repossess houses where the mortgage loan had gone into default.

[1] This paper does not describe the trail followed in dogged pursuit of housing credit since the early 1990s, as this story has been fully documented in (Tomlinson, 1999; Tomlinson, 2002; Rust, 2002a; Rust 2002b).

[2] The key housing finance institutions set up to facilitate the delivery of housing finance are described at the end of the article.

[3] Black South Africans were legally barred from purchasing housing for ownership, using a mortgage bond, until the late 1980s. Within just over a year, these first-time home-buyers saw the interest rates charged on their bonds rise from 13% in 1987 to 20% in 1989, severely threatening their ability to repay the loans, forcing many of the households into default, and resulting in the first repayment boycotts (Tomlinson, 1997).

Key to the policy, launched in 1994, was the delivery of a once-off capital subsidy - the Housing Subsidy Scheme (HSS) (Department of Housing, 1994). It has been available to all households with an income of less that R3,500 (USD $580) per month. In 1994 the amount of the subsidy was R12,500, but has increased over time to R31,900 in 2005. While the subsidy is able to deliver a serviced site, and more recently a rudimentary structure[4], it is widely acknowledged that the amount of money available has been insufficient to provide a 'four-roomed' house, the vision promised by the ANC politicians at the time of the 1994 elections. Nevertheless, since 1994 government has spent R29.5 billion to provide 1.6 million housing opportunities (Department of Housing, 1994) to low-income households.

By linking subsidies to mortgage loans, the expectation was that households would be able to afford a conventional house. However, due to affordability constraints very few subsidy beneficiaries (less than 10%) have accessed mortgage finance (Public Service Commission, 2003). A commitment to providing credit was therefore needed from the financial sector to provide the end-user finance, which could make the vision a reality.

GOVERNMENT'S RESPONSE: COMMUNITY REINVESTMENT-TYPE LEGISLATION

Going back to the early 1990s, there was often a demand from the 'left' in South African politics to introduce CRA-type legislation in South Africa. In more recent years this view was taken up by government arguing that the South African banking sector was not taking sufficient positive action to address the housing finance needs of the low-income, previously disadvantaged population. Moreover, the banks were viewed as practicing 'red-lining' as a way of discriminating against low-income households, consistently denying them mortgage bonds in particular geographic areas, eg the former black townships and the inner-cities where black people moved following the lifting of the Group Areas Act (GAA) in 1991 – the GAA forced race groups to reside within their own areas.

Modeling itself, to some degree, on the United States the South African government began systematically rolling out a package of legislation, beginning with the Promotion of Equality and Prevention of Unfair Discrimination Act, 2000 (similar to the US Fair Housing Act) followed by the Home Loan Mortgage Disclosure Act, 2000 (similar to the US Home Mortgage Disclosure Act) and in 2002 a Community Reinvestment (Housing) Bill.

In a nutshell, the Equality Act makes it an offence to discriminate on the grounds of race or gender. The Disclosure Act, which by 2005, had still not come into operation, sets out what financial institutions must disclose in terms of their home loan business with the intention of identifying problem areas where lending is not occurring. More specifically, the lending figures expected to result from the Disclosure Act were supposed to reveal which retail banks were and were not lending, how much they were lending and where, and to whom they were lending. This second piece of legislation grew out of government's frustration in trying to 'guess' how much lending the retail banks were actually doing in the low-income market.

The CRA Bill, which followed in 2002, focused on extending housing finance to un- and under-served communities as revealed through the Disclosure Act. The CRA Bill was drafted to compel financial institutions, in the business of providing home loans, to set aside a portion (to be prescribed) of their home loan funding for lower- and middle-income households. Similar to the United States legislation, the Bill specifically states that in making such finance available, financial institutions are not expected to resort to 'unsound' lending practices.

The key provision in the Bill states that if a financial institution is unable to meet its targets by *direct lending* to the target population then it may opt for one of the following:

- providing funding through a prescribed wholesale lender at a mutually agreed interest rate for on-lending to niche lenders to provide end-user loans;
- purchasing wholesale lenders' securities and debt issues; and
- providing funding directly to niche market lenders (defined as a financial institution for which more than half of its outstanding Rand volume of home loans are to households with low- or medium-income levels) to make available for end user loans.

In reviewing the Bill one could argue that in drafting it with the above provisions government was to some degree acknowledging that the formal retail banks might not be able to do profitable business in the low-income market, and therefore gave them a variety of options to meet their targets. In other words, if there were other lenders, eg alternative non-bank ('niche") housing lenders that were able to profitably lend in this market then individual banks could partner with them to fulfill their targets.

Other critical points of the Bill include:

- a 'financial institution' is defined (in addition to the traditional retail banks) as any other registered institution whose business is, in full or in part, either the acceptance of deposits from the general public or the advance of credit with the security of a registered mortgage bond or any other accepted security (eg pension/provident fund benefits); and

[4] With the adoption of the National Housing Code (2000), basic minimum standards have been set down which require a rudimentary structure of 30 square metres be provided on a serviced site.

- a financial institution must abide by the principles of courtesy, transparency and openness in dealing with potential borrowers[5].

In evaluating the proposed legislation, it has been argued that the United States approach to the CRA was based on needs and circumstances peculiar to that country (Diamond, 2002). In the United States in the 1960s and 1970s, concern grew over the socio-economic decline of central city residential areas, often as a result of red-lining through which lenders would determine certain geographic areas to be un-mortgageable because of perceived high credit risk due to declining property values. The US legislation was therefore directed more at geographic areas than at low-income households.

Subsequent examinations (Diamond, 2002) of the United States' CRA legislation have revealed it to be only 'mildly stimulating' in terms of depository institutions making loans to distressed areas. The legislation provided for the use of regulatory factors, such as being able to withhold permission for banks to consolidate unless they met the credit needs of the entire geographic area they were located in, ie chartered in, to nudge the banks to extend their lending.

More specifically, performance was to be assessed through regular examinations, however, sanctions would only come into effect when an institution requested, eg a change of licence, wanted to relocate a branch and so on. The legislation did not, therefore, 'compel' banks to lend but rather 'encouraged' them to do the right thing, with the result of this approach, over a twenty-year period, being fairly minimal.

Subsequently Temkin (in Diamond, 2002) has noted that it was the Financial Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) enacted in 1992, which placed a requirement on the two Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac to broaden their reach to actual low-income households, that eventually made a significant difference to the lower-end of the U.S. housing market.

HOW APPROPRIATE IS CRA TO SOUTH AFRICA?

At the time the South African Community Reinvestment Bill was drafted, it was acknowledged that the situation in South Africa was very different. For one thing, in the United States banks are limited as to where they can operate through the requirements of federal and state charters. In South Africa, the Big Four retail banks (Standard Chartered, Nedbank, RMB and ABSA) operate throughout the entire country and are not dependent on government permission for where they carry out their business or how they structure it.

Second, because of the reversed demographics whereby in the United States the lower-end of the market is the minority, but in South Africa, the lower-end of the market makes up the majority, the potential for systemic risk to the United States' banking sector is much lower if its banks wind up doing a degree of 'unsound' lending. In South Africa the risk to the banks from 'unsound' lending is much higher because the numbers are so much larger.

Moreover, 'red-lining' a geographic area in South Africa has often arisen because of repayment problems. These repayment problems began as tool of the 'struggle' in the early 1990s and then drifted over into being the result of economic hardship, which was resulting from the loss of 500,000 formal jobs over the past decade. Obviously, in comparing the situation in the two countries, the type of abnormal repayment situation, which has grown up, and to some degree become endemic, in South Africa, is not something the United States has had any experience in dealing with.

The issue then was whether to take a more aggressive approach, which could take the form of introducing geographically-based lending targets, which could result in 'unsound' lending, as a response to the bank's 'red-lining' or simply to promote the 'extension of lending' to the population being targeted. In the end the Bill veered from the United States' approach in two ways. First it 'compels' the banks, rather than nudges them, to carry out lending. It focuses, however, on targeting 'income levels' rather than 'geographic areas', a clear distinction when applied to the local situation.

THE FINANCIAL INSTITUTIONS RESPOND

As expected the South African financial sector rapidly rose to meet the challenge by warning the markets that the government was going to compel them to carry out 'unsound' lending, which would have the effect of unnerving overseas investor confidence, resulting in a lowering of the banks' share prices.

In determining its response, the financial sector, it appears, was sufficiently worried about the proposed legislation to move proactively to sideline the Bill by proposing its own Financial Sector Charter.

Financial Sector Charter (FSC)

In October 2003, the financial sector[6] announced its commitment to a transformational Financial Sector Charter (FSC) (Banking Council, 2003) for the industry that would provide for increased access to financial services for poor households and communities, and direct billions of Rands of investment into transformational infrastructure, agricultural development, low-income housing (R42 billion) and SME businesses (R5 billion).

By 2003 a Low-income Housing Task Group had been established by the financial sector

[5] This point arose from the fact that low-income people have often felt there were being treated discourteously by employees of the retail banks.

[6] A financial institution means a bank, a long-term insurer, short-term insurer, re-insurers, managers of formal collective investment schemes in securities, investment managers and other entities that manage funds on behalf of the public, including retirement funds and members of any exchange licensed to trade equities or financial instruments in this country and entities listed as part of the financial index of a licensed exchange.

to determine the broad outputs that were desired from the process. It was determined that all parties committed to the Charter would work in partnership with government and its Development Finance Institutions, eg the National Housing Finance Corporation, to commit themselves to mobilizing resources.

Through the Charter process, Government wanted to see, eg:

- sustained transformation in the manner and scope of engagement by the financial sector in historically under-serviced markets;
- greater penetration of private sector housing finance;
- increasing private financial support for a greater range of tenure and housing options; and
- the elimination, where it might exist, of unfair discrimination.

During this past year a package of measures key to unlocking finance through appropriate risk-sharing arrangements were proposed by the financial sector to government. The banks, being well aware of their obligation to both shareholders and depositors are keen to push for a cautious and balanced approach to low-income housing funding in extending their commercial risk beyond the conventional mortgage market where they currently operate. In formulating proposals, there is a recognized need for government support. Some of the support they have been negotiating with government has included:

- development of a securitisation (conduit) model[7], with government participation in its funding, as a means funding lending via a secondary market mechanism;
- Loss Limit Insurance, which would cover some of the abnormal 'political' risk still associated with this market and underpin the securitisation model;
- development of a Fixed Interest Rate loan[8] product to address the volatility in rates, which has been key to pushing low-income households into default.

Other issues being examined in relation to the establishment of a 'conduit' are where to house it, either in the private or public sector, and whether an institution already in operation should be used, or an entirely new institution should be created.

In addition, there is a commitment to normalize under-performing markets. This proposal takes the form of government and the financial sector developing a common approach to tackling selected pilot areas where repayment problems have continued to this day. Initiatives to break these logjams would focus on working with the local authority, community groups and so on to tackle the problems

Some tensions have arisen in the Charter process in that, on the one hand, it is framed around a strong delivery oriented work programme to be driven by targets and timeframes. On the other hand it is aimed, over a much longer period, at transforming the entire sector. Moreover, in implementing the Charter's goals, strategies for doing so cut across a number of areas of responsibility for formulating and implementing proposals, including banks operating individually and collectively and the financial sector acting with and without government. For example, the targets that have been set are divided into those the banks believe they will be able to meet without government support and those requiring government support (as described above). More specifically, the banks are of the view that there is a certain level of additional credit they will be able to extend even if the government, in the end, does not agree to the supports being proposed. Only time will tell whether they find themselves having to move forward on their own, or with government support.

GOVERNMENT'S NEW HOUSING STRATEGY

The timing of this initiative comes just as government has recently released its own new housing strategy, Breaking New Ground …(Department of Housing, 2004). In the first ten years of the housing policy, government focused on addressing the country's housing backlog as rapidly as possible, resulting in a single-minded focus on 'quantity', while critics note, ignoring 'quality' (Kahn & Thring (eds) 2003). The new vision shifts away from the 'quantity' to the 'quality' of housing delivery, and particularly the delivery of sustainable human settlements, which will be better located, accessible to economic activities, provided with social and cultural amenities and so on. Most noteworthy is government's decision to extend its role to that of supporting the entire residential property market, not just the low-income market, as a means of 'breaking the barrier between the first economy residential property boom and the second economy slump' (Department of Housing, 2004: 7).

In its new housing strategy, government commits itself to expanding its scope and mandate to include households earning up to R7,500 per month by investigating the provision of a mechanism to overcome this portion of the market's down-payment barrier. This move in itself, if implemented, would ensure a greater number of borrowers for the banks to serve. Besides the financial mechanisms that are on the table, the Department of Housing also intends finally establishing an Office of Disclosure, as called for under the Home Loan and Mortgage Disclosure Act, as a means of monitoring the banks' performance, critical to determining whether the banks are delivering on their promises around low-income housing finance.

Where for the past ten years these two adversaries, the banks and government, have been locked into their own perceptions

[7] The proposal is for the development of a conduit for selling paper into the capital markets as a means of increasing lenders' funding capacity.

[8] The local banks do not believe there is sufficient market opportunity in South Africa for the private-sector to hedge the interest rate risk and are looking at international examples of where government has stepped in to take on a portion of lenders' risk.

as to whose fault the lack of lending belongs, it is now apparent that there is a tacit agreement to discard this chicken-and-egg mentality in favour of accepting the realities of the low-income market and then working out realistic joint proposals to deal with them. The willingness of government to both acknowledge and accept some of the risk of doing business in this market should be viewed as a clear change in its mindset. Expectations have been raised and promises have been made. The results will be for all to see.

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SOUTH AFRICAN HOUSING ORGANISATIONS

National Housing Finance Corporation – established in 1996 as a wholly-owned South African government state-mandated Development Finance Institution (DFI), operating as a public company. It mission is to formulate initiatives that will mobilize housing finance for low-to-moderate income households, by providing wholesale finance and underwriting funding for retail financial intermediaries and social housing institutions – see www.nhfc.co.za.

National Urban Reconstruction and Housing Agency – set up by government in 1995, as a Section 21 (not-for-profit) company to provide bridging loans to developers and contractors managing the construction of low-income housing projects – see www.nurcha.co.za.

Rural Housing Loan Fund – established in 1996 as a Section 21 (not-for-profit) company with a grant of DM 50 million of soft capital from the German Development Bank (KfW), its mandate is to assist very poor people living in the rural areas to improve their housing conditions. It does this by providing wholesale finance to retail intermediaries operating in the rural areas - see www.rhlf.co.za.

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