The risk of unsecured lending in South Africa

The share prices of South Africa’s African Bank and Capitec Bank saw significant downward pressure last month as a result of fears over exposures to unsecured lending. In this Leriba Report we discuss the background to the unsecured lending issue and scenarios for how it may resolve.

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History of unsecured lending in South Africa

The first major growth phase in unsecured lending was in the mid-1990s to early 2000s. In 1992 an exemption was granted for small, short-term loans, from the normal restrictions of the Usury Act. This was done mainly in an attempt to widen access to financial services to include black South Africans who had been systematically excluded from the formal sector under Apartheid. The banks argued that the interest rate caps of the Usury Act made it impossible for them to make small loans, of the sort needed by poor black South Africans looking to enter the formal system.

The exemption covered loans of R6 000 (from 1999, R10 000) and shorter than 36 months in duration, and allowed a microloan industry to rapidly develop in South Africa. By 1999, total microlending in the country had reached R15 billion, encouraged by the first democratic government elected in 1994.

The exemption framework meant that such microloans effectively operated in a regulatory vacuum. Abusive practices became rife. Many lenders charged exorbitant rates while carrying almost no risk. A focal point for the industry became the civil service, from which repayments could be collected through deductions from the central government payroll, which had been allowed from 1993. Some civil servants found themselves with no take-home pay after deductions had been made.

In 1999 the Micro Finance Regulatory Council was established as a regulatory body for exemption-related lending, as a first step toward tackling the abusive practices in the industry. All organisations providing loans in terms of the exemption were required to register with it, and it had some powers to inspect and discipline members for violations of its codes of practice.

The first microloan crisis

In the late 1990s, as a response to the rapidly weakening rand in 1998, monetary authorities sharply increased interest rates to attract capital into the country, reaching a peak of 25,5% in September that year. This led to a spike in defaults across the banking system and triggered a crisis in its small banks sector

The democratic government had attempted to liberalise the financial sector and increase competition, so had licensed over a dozen new banks to operate. These tended to operate duration-mismatched balance sheets, holding short term deposits to fund long term loans, with statutory capital ratios of 10%.

Figure 1: Interest rates and bad debt in South Africa

source: Inet Bridge/Leriba
This balance sheet risk and the real and perceived erosion in asset quality in the late 1990s led to significant outflows of funding from small banks in favour of large banks. A number of small banks collapsed, others wound themselves up or were sold to larger institutions. While this was dubbed a small banks crisis, it was not seen as systemic and there was limited intervention by banking supervisors.

However, in 2000 the government decided to act aggressively to end microlenders’ (and everyone else, including insurance companies) access to deductions from civil servants’ salaries. It summarily terminated lenders’ access to the Persal payroll system. This was to have a catastrophic impact on the banking system.

At that point there were three major lenders in the market which had built substantial books of microloans – Saambou, Unifer (a subsidiary of Absa) and African Bank, alongside hundreds of other small lenders. Collectively, they had built microloan books worth over R14bn, much of it collected through deductions to civil servants’ salaries. This collection mechanism was heavily relied on. The banks did minimal assessments of borrower affordability, bank account management, or any other traditional credit scoring techniques. Loans were pushed out to civil servants, knowing the collection mechanism was almost fail safe. The union-aligned ANC government was highly unlikely to retrench anyone.

The sudden closure of Persal deductions was devastating. Banks scrambled to set up bank account debit orders as an alternative collection mechanism while furiously lobbying government to continue deductions. African Bank had anticipated the change to deductions and had been rapidly evolving its book out of the civil servant space, relying to a greater extent on company payroll deductions through joint product offerings and on bank debit orders. But Unifer and Saambou were ill prepared.

The first to collapse was Unifer, 61.3% held by Absa, in January 2002. Without Persal deductions, the performance of its book collapsed. By December 2001, it had net liabilities of R1.14bn, having underprovisioned for bad debts by R1.78bn. Absa, under pressure from the Reserve Bank, moved in to rescue it, buying out minorities and integrating Unifer into its operations.

The Unifer experience made the market nervous, turning attention on African Bank and Saambou. In early February 2002 a rumour (later proved true) circulated that Saambou’s auditors KPMG had filed a report to the Reserve Bank indicating their concern over its going concern status. In the space of a day, R1bn in deposits was withdrawn from the bank. Despite a rescue deal proposed by Investec and backed by the Reserve Bank, South Africa’s minister of finance, Trevor Manuel, decided to put the bank into curatorship believing at the time that it was solvent and could be wound up. As it happened, the bank in fact was insolvent to the extent of about R7bn, which the government was forced into covering in order to bail out depositors. The main cause of insolvency was its microloan book, almost
half of which turned out to be bad. Manuel also believed that Saambou was not a systemically important bank.

The collapse of Saambou had an unexpected impact on the market. The small banks crisis had been an example of downward contagion – a bank in trouble usually led to a loss in confidence of smaller banks. But after Saambou collapsed, confidence eroded in larger banks. South Africa’s sixth largest bank BoE became the target of depositor withdrawals, despite it having almost no exposure to microloans and no doubt over its solvency. The Reserve Bank recognised a clear crisis was evolving in the banking sector and stepped in with unlimited liquidity support for BoE. The Bank and the minister of finance issued an unprecedented open ended public guarantee for all of BoE’s deposits, making it technically the safest bank in the land. But withdrawals in fact increased, with the public seeing the guarantee as confirmation of a crisis. In addition, though it was never made public at the time, Invested, the fifth largest bank, saw an increase in its withdrawals.

The only solution was for a larger rival to buy BoE. This fell upon Nedbank, which had clear acquisitive ambitions, frustrated two years earlier when its effort to buy Standard Bank had been blocked by regulators. Nedbank’s acquisition of BoE allowed the authorities to withdraw their unconditional guarantee and the panic in the sector subsided. In the space of three months, the country’s sixth, seventh and eighth biggest banks had all been removed. While the political authorities had made the wrong call in putting Saambou into curatorship (which cost tax payers over R7bn) they responded very aggressively to stem the crisis. It did however cause a significant panic at the political level, the after effects of which are still with us today.

While it came under significant pressure, African Bank survived the crisis. Also, in the midst of it, Capitec listed on the JSE as a new rival for African Bank. The two were to continue to lead the market in unsecured lending.

The next boom in lending

Following the 2002 crisis, the government began working toward an overhaul of the entire credit regime. This process was led by the MFRC which was to become the seed institution of the National Credit Regulator which was introduced in 2007 in terms of the National Credit Act. The Act was promulgated by the department of trade and industry, which remains the lead political overseer for the implementation of the act. The NCA opened a market for high interest rate loans in South Africa by doing away with the exemption from the Usury Act, which had restricted the unsecured lending industry to loans under R10 000 in value and on terms of less than 36 months. All lending in South Africa was now governed by the NCA and all lenders had to register with the NCR.
Some of the features of the NCA regime are:

- Interest rate caps are now in force for different credit types. For instance, the cap for unsecured credit is now the South Africa Reserve Bank’s repo rate, times 2.2, plus 20 percentage points. Currently that works out to be 31% annually.
- Any institution with more than 100 credit agreements or a credit book of more than R500 000 must register with the NCR. Those who fail to register can incur financial penalties and have their loan agreements declared null and void.
- The act is silent on other charges that may be levied alongside the loan, such as initiation fees or insurance such as credit life policies that can be attached to the loan. That means the actual repayments and profitability of a loan can be significantly higher than the annual rate being charged.

This naturally opened the space for a whole new industry in the form of larger unsecured loans. However, in 2007 the financial crisis intervened, substantially sapping demand for credit in the South African economy. Institutions, particularly large banks also become risk averse, increasing credit granting stringency across the board. This served largely to delay the take-off of unsecured lending.

Growth began accelerating in 2010 as consumer confidence returned to the market. This growth was also driven by a number of other factors including:

- Large banks and other lenders entered the market
- Formal employment, particularly in the civil service, widened the borrower pool
- More stringent borrowing criteria for home loans forced many borrowers into the unsecured market

In the process the unsecured credit market evolved from a microloan market into a large, middle-class focused credit business. The nature of the typical loan and borrower shifted dramatically over this period. Unsecured loans range up to R230 000 of value and 84 months in repayment terms.

Trend 1: Higher income borrowers became much more significant borrowers (see figure 3). Those earning over...
R15 000/month now account for the majority of all new loans (41% of all loans granted most recently), while the typical low income borrower (<R3 500/month) has remained a fairly static proportion of the overall loan pool.

Trend 2: The size of unsecured loans has increased dramatically (see figure 4). A number of factors have driven this trend including:

- Higher affordability levels of higher income borrowers
- Increasing wage rates of lower and middle income earners in South Africa
- The growth of “consolidation loans” which take a number of smaller loans granted by competitors and consolidate them all into a single facility. Sometimes this is done through the debt counselling process with other lenders offered a fraction in the rand for their loans
- The effort to “capture” clients by granting them a large facility that fully consumes their affordability, thereby closing out access to the client by other borrowers in terms of the NCA’s affordability testing restrictions. Our studies of the market have found many lenders who offer clients substantially more than the client actually wants in order to absorb their full capacity

It is difficult to determine exactly which institutions have driven this growth and changing demographic of borrowers. Our research suggests a wide range of new entrants into the credit market including insurers, retailers, and specialist lenders. This has substantially increased competition for clients. Such competition has not led to significant price competition but rather to a “race to the bottom” in credit vetting criteria. In order to grow their book, many lenders will accept lower quality clients than their competitors. Our interviews with key players in the industry suggests that actual pricing does not vary much from the 31% cap the NCA provides.

Clearly a major source of growth in the industry has been from the four large South African retail banks, which entered a market dominated by African Bank and Capitec. They have been attracted by the far higher margins in unsecured lending than found in other forms of credit. Consider the margins of the big four banks:

**Table 1: Margins of big four South African banks**

<table>
<thead>
<tr>
<th></th>
<th>FirstRand</th>
<th>Nedbank</th>
<th>Standard Bank</th>
<th>Absa</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average margin (%)</td>
<td>y-o-y book growth (%)</td>
<td>Average margin (%)</td>
<td>y-o-y book growth (%)</td>
</tr>
<tr>
<td>Home loans</td>
<td>1.4</td>
<td>1.9</td>
<td>1.7</td>
<td>-5.5</td>
</tr>
<tr>
<td>Vehicle finance</td>
<td>4.9</td>
<td>21.5</td>
<td>4.6</td>
<td>10.3</td>
</tr>
<tr>
<td>Credit cards</td>
<td>8.7</td>
<td>5.5</td>
<td>8.5</td>
<td>16.1</td>
</tr>
<tr>
<td>Personal loans</td>
<td>15.5*</td>
<td>93.7</td>
<td>14.1</td>
<td>28.7</td>
</tr>
</tbody>
</table>
With the exception of Absa, which made an explicit decision to reduce its unsecured lending, unsecured lending has been the biggest growth area for the big banks. The motives for doing so are obvious – unsecured lending provides by far the largest margins in the retail banking segment. The financial crisis was particularly hard on home loan lending businesses because property values fell at the same time as defaults spiked. This damaged returns and the businesses are trapped by long term loans priced at uneconomic levels that can have up to 15 years still to run.

Banks are also encouraged to move into unsecured lending by the requirements of Basel 3, which South African authorities have enthusiastically implemented. While South African banks have no problem meeting the capital requirements of Basel 3, they find it far more difficult to meet the liquidity provisions because of the high proportion of overnight money market funding in banks' liability mix. As a result they are under pressure to reduce the maturity profile of their asset mix, so encouraging the growth of shorter term unsecured lending relative to longer term secured lending.

But the growth in unsecured lending among the formal banks, including African Bank and Capitec, is not where the most abusive practices take place. Many of the anecdotes about aggressive threatening collection methods are done by debt collectors who have bought books from larger lenders. These debt collectors are free of the regulatory oversight faced by big banks and other registered lenders and therefore far more likely to be use unsavoury if not illegal tactics. One of the tactics employed is the illegal use of emolument attachment orders, which are a court order requiring employers to deduct repayments from their employees' salaries. There is evidence that collectors have bribed clerks at magistrates courts to sign the orders. These orders in many respects fail to meet the legal requirements for their issue, and often include grossly inflated collection fees and interest rates in violation of South Africa's in duplum rule which caps maximum loan exposures at 50%. Many collectors also ignore that any loan obligation proscribes after three years.

Our research has also found some less formal lenders who get clients to sign an acknowledgement of debt form at the time the loan is issued. The lender can then fill in an outstanding balance at a later date and use it to obtain an attachment order.

Our research indicates that the abuse of attachment orders (often called garnishee orders) is focused outside the formal bank sector, used by retailers and other small lenders. African Bank, for instance, only collects on 10 000 loans through garnishee orders which appear to have been legitimately obtained.
Another clear factor that has contributed to consumer indebtedness is the additional charges that are levied on loans beyond the interest rate itself. These include initiation fees and insurance charges, which are often made compulsory for the borrower to obtain the loan. Research commissioned by the NCR showed initiation fees of up to R1 140. Insurance fees on average added 10,6% to the cost of the loan. Figures obtained by the NCR from the top 10 unsecured lenders in the market showed that revenue sources are as per figure 5.

**Understanding the politics behind unsecured lending**

An alarm bell was sounded over the growth of unsecured lending early in 2012 when figures for the fourth quarter of 2011 were released that showed unsecured lending had grown 47% in Q42011. This led to some rash statements from the political level in South Africa, such as higher education minister and Communist Party head Blade Nzimande who described it as a “time bomb” comparable to the US subprime crisis.

Various political interest groups have different views and vested interests regarding unsecured lending. A common view in the ANC is that unsecured lending is one of the factors driving South Africa’s often violent wage negotiations. Heavily indebted employees become desperate for increases with their take-home salaries because of repayment deductions. This is thought to be a major cause of strikes in the civil service. Some have also suggested it is one of the factors behind the violence at Marikana earlier this year that led to the fatal shooting of 34 mine workers by police.

There is also a view in some political circles that unsecured lending and the black listing of defaulters contributes to unemployment because potential employers undertake credit checks. This seems to suggest irrational behaviour on the part of employers. This is cited as one reason for a credit amnesty currently being proposed which will see credit bureaus being forced to delete the adverse credit information they hold about certain categories of borrowers.

There is also a clear view among the ANC’s leftist allies that unsecured lending represents one of the worst abuses of capitalism and amounts to predatory business. The practices of some debt collectors are frequently cited. It has been suggested that the garnishee system should be summarily terminated to prevent its abuse.

![Figure 5: Revenue from unsecured personal loans](source: National Credit Regulator)
Among the financial cluster in government and the Reserve Bank the memories of the 2002 crisis are still fresh. There is clearly concern that the rapid growth is similar to that of 1999-2002 which led to the last banking crisis. Those in this camp argue against a termination of the garnishee system out of fear it will have a similar impact as the termination of Persal deductions in 2001 which directly contributed to that crisis.

In the background, African Bank’s senior executives have been raising the alarm among regulators about the growth of unsecured lending. This has been a sign of benevolent interference. African Bank has the most experience in the market and has a good reputation for anticipating problems before they materialise. In August 2012 it first raised its concerns about the speed of growth of the sector, saying that defaults were showing a worrying trend. It has since lobbied the Reserve Bank and the Banking Council to take clear steps to slow down the rate of growth. Its warnings have led the market to increase provisions and cut back on lending volumes.

Surprisingly, the political level has not yet commented on the displacing of home loans by unsecured lending. Home loan borrowing is significantly more economically productive in financing fixed capital formation, helping employment. We believe this feature will emerge as a source of political opposition to unsecured lending in the future.

**Is there a crisis brewing?**

No. The one major difference between 2002 and now is that very little depositor funds are exposed to unsecured lending. African Bank is almost entirely funded out of bond issues and equity. For the big four banks, unsecured lending is such a small part of their balance sheets that they could easily withstand a dramatic spike in bad debts. For Capitec, which derives some 40% of its funding from retail deposits, the risk is sufficiently low to not be concerning. There is no risk of bank collapses leading to a loss in confidence among depositors.

The Reserve Bank has conducted its own study and declared there is no systemic risk. The total unsecured lending book is now R453bn among banks, less than 13% of banking assets of R1,3bn. This is based on the SARB’s definition of unsecured lending, which includes overdrafts and credit cards which are categorised differently in the NCR’s figures.
Nevertheless there are clear signs that unsecured lending is seeing a spike in bad debt. All of the big four banks have noted in recent commentary that they have increased provisions amid worsening loan performance. Partly this is because of the major growth in the middle class segments of the market with large numbers of new providers have targeted their lending at this segment. The poor economic performance of the South African economy, which registered surprisingly low growth of 0.9% for Q12013, has placed significant pressure on this area of the market.

Unsecured lending is still growing but at a slower rate. Figures from the SA Reserve Bank are slightly more up to date, though less specific, than those for the NCR. These show that the “other loans and advances” segment of total private sector credit extension actually exhibited a decline in April 2013 compared to March 2013. The SARB figures include only banks while the NCR’s include other lenders, but they provide a strong suggestion that lending in Q22013 is showing a dramatic slow down.

Of course, the real issue for bank profitability is the performance of existing loan books. The advantage with unsecured lending is that they have a short duration, so bad loans can be worked out of the system faster. The NCR’s figures do, however, show a clear increase in accounts that are past due. In the fourth quarter of 2012 the number of accounts reported as current had fallen to 65.88% from 71.08% the quarter before (see figure 7).

The indications are that market performance has worsened since. African Bank’s commentary on recent results was that March displayed a surprisingly poor payment performance, leading the bank to make unanticipated additional provisions to cover losses.
Conclusion

In the case of African Bank specifically, we are more sanguine about its prospects than the rest of the market. The bank has proven itself able to anticipate problems and provide for them before they strike. Our interviews have made it clear to us that the bank has led the engagement with authorities over unsecured lending rather than followed it. It has helped put pressure on the rest of the market to slow down lending, ensuring that its clients have less chance of becoming over indebted to other lenders. The bank has attempted to lobby to prevent the “race to the bottom” that was characteristic of the market.

There is clear evidence that the rest of the banking market has now dramatically slowed down its lending. We wait for evidence that the non-bank credit market has also slowed down. The challenge then is how the banks manage their existing books and what regulatory change is brought to bear in an attempt to improve the market.

Regulatory change is a clear risk. The National Treasury spooked the market in December when it suggested it may support a summary ban of garnishee orders. Our interviews suggest it has since backtracked, fearful that such a dramatic step would have unintended consequences. The Banking Council has engaged with the National Treasury to form a joint view on needed regulatory amendments. Such amendments will need complex further political negotiation with the DTI which oversees the NCA and the department of justice which oversees magistrates courts and garnishee orders. To our minds the regulatory amendments that would be sensible are:

- A standardisation of the affordability testing that lenders are supposed to do before agreeing to give a loan. The NCA requires such tests be done, but does not specify exactly what they should consist of. A standardised test would help prevent the “race to the bottom” that characterises current competitive dynamics.
- More stringent regulation of the informal industry to force nonregistered lenders out and to substantially constrain the activities of debt collectors which take over nonperforming books.
- More stringent regulation of insurance products (mostly credit life) that are attached to unsecured loans. We expect that such insurance must be made voluntary by borrowers (currently most require it) with all prices disclosed and scope given to borrowers to obtain competitive quotes.
- Better regulation of rate disclosures to consumers to allow for easier price comparisons.
- Less likely, but sensible, would be a remodelling of the consolidated loans register launched in 2002. All lenders should be required to submit their loans and
quotes to the register in real time in order to prevent consumers from taking out multiple loans simultaneously.

Some of these measures would be earnings negative for operators in the industry. However, formalising the industry is likely to favour the larger lenders that are equipped to do proper credit vetting on a large scale. Insurance revenue is certainly going to decline for some of the lenders alongside other non-interest revenue. There is going to be an increase in bad debts, but this will largely be contained within current provisions.

However, it is clear that there is no risk of a 2002-like banking crisis as a result of the recent growth in unsecured lending. This substantially minimises the risk to the market of major disruption.