Compliance & Risk
RESOURCES

RESEARCH ON THE INCREASE OF UNSECURED PERSONAL LOANS IN SOUTH AFRICA'S CREDIT MARKET

FINAL REPORT

EXECUTIVE SUMMARY

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Prepared For:

National Credit Regulator

Preparing you for the future
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Research undertaken to determine the factors that are causing the increase in unsecured personal loans (from both the supply and demand side perspectives) and the implications thereof for consumers, credit providers and the credit industry

ACKNOWLEDGEMENTS

This research report has been prepared for the NCR. All aspects of the report that has been prepared have been work-shopped with NCR staff members who have provided extensive input and have over the duration of the project actively participated in its preparation.

Research has been carried out with the support, cooperation and assistance of credit providers that have been asked to participate in the study. They have spent a significant amount of time and resources on providing input. The industry experts / stakeholders that participated provided valuable insights and have facilitated an opportunity to identify the factors that are relevant in considering the growth in unsecured personal loans. Sincere thanks are extended to all those that contributed towards the study.

The report has been prepared by Compliance & Risk Resources in the interests of maintaining a sustainable consumer credit market.

1 BACKGROUND

1.1 Introduction

In view of the increase in unsecured credit granted statistics seen in the quarterly Form 39 information received from credit providers by the National Credit Regulator (NCR), research relating to the factors that are relevant to understanding this growth has been conducted. The research was commissioned following the application of the NCR's procurement process and Compliance & Risk Resources was appointed as service provider to undertake a limited scope study.

In order to keep the scope of the research manageable in the light of the project timelines, the focus has been on the unsecured personal loans product, which is the most significant and fastest growing component of the unsecured credit products.

It is noted that unsecured personal loans refers to loans which are repayable over a period of time in installments where there is no security that the credit provider can rely on to recover their debt if repayments are not made.

The study included consideration of insights gained during workshops held with NCR staff members as well as workshops held with industry associations and other regulators. Stakeholders that have an interest in the reported growth in unsecured lending have been interviewed and a number of industry workshops have been held in order to obtain a broad understanding of the implications of the aforementioned on the credit market. Ten credit providers were selected to take part in the study and were requested to submit a research questionnaire and statistical information relating to unsecured personal loans. Interviews were held with each of the credit providers.

It is evident that the increase in unsecured lending has attracted attention from the media and numerous reports covering the unsecured credit growth have been published. Some have raised concerns relating to increases in relatively expensive credit that may result in unsustainable credit growth. There are two overriding considerations from a sustainability perspective in this regard, firstly considerations relating to financial stability or the financial system, and secondly considerations that fall within the consumer protection objectives that have been established in South Africa.

The South African Reserve Bank has published the following perspectives that relate to financial stability[1]:

"One way of defining financial stability is in terms of the requirements to achieve it. It requires a robust financial system, which may be defined as a system having the ability to prevent, predict and withstand shocks under all types of domestic and international market conditions. Financial stability can further be described as the absence of macroeconomic costs of disturbances in the system of financial exchange between households, businesses and financial-service firms. Another definition used by some commentators is that financial stability is a sustained condition of stability in the financial system that ensures the efficient functioning of institutions and markets and low volatility in prices, interest rates and exchange rates. When the whole or an important part of the financial sector is at risk, the situation can be described as financially unstable."

[1] South African Reserve Bank. http://www.resbank.co.za. Referenced 25 June 2012.

It is noted that consideration of the above does not fall within the scope of the research project conducted. This report specifically addresses key aspects of sustainability in the light of the significant expansion of unsecured personal loans business by credit providers, with the focus of the study on consumer protection matters that fall within the ambit of the NCA requirements and the NCR's supervisory mandate. This should be seen in the light of the stated purpose[2] of the NCA, i.e. "to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry".

The respective variables that influence both the supply and demand side of the growth seen in unsecured personal loans cannot be viewed in isolation and are multidimensional and complex. For instance, credit providers are not, in the current industry conditions and regulatory framework, incentivised to offer mortgages to clients to the extent that they were in the past, i.e. prior to the financial crash in 2008. The somewhat constrained growth that has been seen in mortgages has in turn had the effect of increasing the demand for unsecured lending products. Other factors that have influenced the supply of credit include the margins that can be made in respect of unsecured personal loans in the changing shape of the credit market. The extent to which unsecured personal loans demand is maintained at current levels will depend on various market conditions, however, the indications are that, in the short to medium term, there will be continued high growth in unsecured lending products.

1.2 Objectives of the research

As stated in the study terms of reference:

"The objective of the research undertaken is to determine the factors that are causing the increase in unsecured personal loans (from both the supply and demand side perspectives) and the implications thereof for consumers, credit providers and the credit industry".

This was designed to assist the NCR to gain an understanding of the growth in unsecured personal loans and inform policy on consumer credit competency and lending practices.

2 EXECUTIVE SUMMARY

The reasons for the growth in unsecured lending are complex and multidimensional in nature and the drivers of credit supply and demand behavior cannot be singled out and analysed in isolation.

There are numerous interrelated considerations that have a bearing on the credit market developments that have been tracked by the NCR in respect of the high growth in unsecured lending. As shown in the lending statistics that are maintained by the NCR, mortgage advances have grown at a relatively constrained rate since the financial crash in 2008, which have, to an extent, meant that consumers that could in the past have had access to mortgage finance may now opt for unsecured credit to meet their needs. This

[2] Section 3 of the National Credit Act No. 34, 2005

low growth in mortgages is due to a number of factors including: Unfavourable property market conditions with depressed property market values, costs relating to bond origination, difficulties in realising security where credit providers experience challenges in evicting tenants, debt review process challenges, relatively low margins and an anticipated increase in capital requirements.

It is noted that unsecured personal loans are not a full substitute for secured lending due to the product features thereof, particularly in respect of mortgages that have long repayment terms, but can be seen as complementary. However, with the advertised increase in the maximum unsecured personal loan amount offered by a credit provider to R230k over a maximum period of 84 months, the range of expenditure that a consumer can finance is extended (although at this juncture a relatively low proportion of loans have large balances).

The demand for unsecured personal loans is seen in the increasing number of applications that have been made by consumers. This is a product that credit providers have focused on in meeting the demand for credit. Factors that have influenced growth in this regard include the relative ease and speed at which the likes of unsecured personal loans can be obtained.

Unsecured personal loans have represented an attractive market opportunity for credit providers who have actively pursued a lending growth strategy in this product, particularly as a result of the margins that can be made in the current market.

The respective debtors book balances and year-on-year growth relating thereto is shown in the table below.

Figure 1 – Summary of gross debtors book

Credit type	Balance Rand Value Q1 2012	% of Total	Y-On-Y Growth Rand Value	Y-On-Y Growth %
Mortgages	796 329 489 998	60,3%	26 438 075 909	3,4%
Secured Credit	255 553 185 573	19,4%	29 205 139 923	12,9%
Credit Facilities	147 340 976 725	11,1%	14 309 377 159	10,8%
Unsecured Credit	120 811 141 417	9,1%	39 946 611 269	49,4%
Short-Term Credit	882 031 713	0,1%	184 549 294	26,5%
Total	1 320 916 825 426	100,0%	110 083 753 554	9,1%

Source: NCR

Mortgages remain the dominant product, which represents some 60.3% of the overall credit book in respect of Q1 2012. This has reduced from 62.7% in respect of Q4 2007, i.e. in the light of the constrained growth mortgage book growth with Q4 2011 y-on-y growth recorded at R26bn, 3.4%. On the other hand there has been strong Q1 2012 y-on-y growth in unsecured lending of R40bn, 49.4%, although this was off a relatively low base.

It is evident that the mass and middle market demand for credit was recognised by organisations such as African Bank and Capitec, which have been effective in targeting this segment and have successfully grown their lending books in recent years. Business opportunities in this regard have also been recognised by the larger banks, which have implemented business plans that include growth in the unsecured lending sector of the market.

The high proportion of consumers with impaired accounts at credit bureaus is a concern from a consumer credit health perspective. It is submitted that the level of indebtedness should be viewed from 2 broad perspectives. Firstly, from a consumer credit standpoint at an individual affordability level, e.g. from the point of view of the adequacy and effectiveness of the procedures that have been developed and implemented by credit providers. Secondly, from the perspective of the overall level of indebtedness of consumers in South Africa, ideally in respect of an appropriate categorisation of consumers at a national level.

Access to credit, pricing levels and credit risks are inextricably linked. For example, unsecured personal loans are often offered to consumers that do not qualify for other forms of finance due to their risk profiles. Consumers that represent higher risks will be charged higher interest rates and it will be anticipated that there will be a relatively high level of overdue accounts and defaults in respect of such clients. It is, accordingly, not surprising that these consumers are reported to have a significant level of impaired accounts with credit bureaus. If it is accepted that, at an overall industry level, some 38% (the estimated proportion ranges from 38% to 46% depending on the information source / basis used) of consumers have accounts that are more than three months in arrears (in respect of all types of credit and financial commitments), then some 7.3 million consumers of the 19.3 million credit active consumers will fall into this category. It has been estimated that some 3.6 million of these consumers are "deeply impaired". Whichever way you look at these figures, they translate into a significant "number of people" that are financially stressed. It is submitted that credit health in the market should be understood from the perspective of the consumer in a holistic manner.

It is reasoned that further regulation of the credit market will not, in itself, eliminate or significantly reduce an undesirable level of debt stress in the market. While it is accepted that there is ground to cover in providing guidelines to the industry in respect of affordability assessment and that improved compliance will certainly be in the interests of consumers and benefits will be derived therefrom, the current credit market framework is geared towards encouraging access to credit and there is an inherent likelihood that large numbers of consumers will have challenges in meeting their debt commitments. Access to credit is facilitated through the relatively high interest rate caps in respect of unsecured personal loans as well as the other revenue streams that are available to credit providers, including credit life premiums. If these are changed, access to credit will be impacted.

Factors relating to both the supply and demand for credit have been addressed in the study. The level of compliance with key regulatory requirements by some credit providers is a concern and it is submitted that benefit will be derived from targeted interventions by the credit supervisor with a view to monitoring and supervising the critical aspects of compliance with the NCA (this is dependent on resources to undertake specific reviews of credit providers including onsite interventions). Certain market practices require consideration and it is suggested that the extent of such practices should be determined. On the other hand, consumer credit behaviour that does not support the development of healthy credit uptake is a concern, for example the so-call "don't want to know" attitude. The question of why consumers are often not keen to find out what their credit status is requires further consideration. Other matters that are relevant in this regard are the general lack of shopping around for quotes and the apparent price insensitivity of some consumers. A broad based consumer education programme will provide consumers with valuable support.

The governance of credit providers is fundamental to the level of compliance with regulatory requirements. All credit providers should have a governance framework and process that is appropriate to their circumstances and business profile. Quick wins relating to compliance can be achieved by supervisors in this regard. This could be developed on the back of the compliance report that has been implemented by the NCR[3], notably in respect of question 12.1, i.e. in respect of compliance assurance.

The factors that should be considered in understanding the increase in unsecured personal loans are highlighted in the table below together with key considerations relating thereto. These include the level of competition in the industry, compliance with applicable NCA requirements, cost of credit, market practices, credit life insurance, risk mitigation by credit providers, level of indebtedness, access to finance, features of unsecured personal loans, effect of alternative methods of funding and the use of credit by consumers.

Figure 2 – Factors for consideration in respect of growth in unsecured personal loans

Factor	Considerations
Level of competition in the industry	The "micro-lending banks" have achieved strong lending growth in recent years. They have specifically targeted unsecured personal loans, a product that facilitates access to finance. This lending growth strategy has been followed by the large banks, having recognised the business opportunity in this regard and credit providers actively compete for market share. However, the lack of consumer "shopping around" for credit and the apparent price insensitivity in respect of a broad base of consumers is a concern from a competition perspective. Notably, the NCA disclosure and other requirements were designed to improve consumer understanding of the credit they take up as well as encourage competition. One of the key outcomes relating thereto should be consumer choice where comparative quotes will provide valuable information in making credit decisions. It is suggested that benefits would be derived from investigating the underlying causes of consumer behaviour that is "installment" focused as opposed to "cost of credit" focused, i.e. where consumers make credit decisions in the light of the affordability of installment amounts payable (usually monthly) without obtaining quotes from different credit providers. A significant amount of unsecured personal loans are written at the margin, i.e. at or close to the interest rate cap of 32.1%. Such

3 NCR Guideline Number 2, September 2010, provides the format and content of the Compliance Report together with instructions regarding the completion and submission thereof. The report must be submitted to the NCR by credit providers annually.

Factor	Considerations
	lending is typically advanced to higher risk customers, who will perhaps most benefit from the NCA requirements. It is suggested that monitoring of business that falls into this category will provide ongoing perspectives needed to understand the effectiveness of consumer protection measures in the light of the market dynamics.
Compliance with applicable NCA requirements	At face value, the participating credit providers are able to show that they have policies and procedures that are designed to ensure compliance with regulatory requirements. The governance framework and process of credit providers is central to the implementation and effectiveness thereof and plays a crucial role in the development of a so called “compliance culture”. However, in the light of representations made at focus group sessions held, interviews with industry experts and meetings held with credit market stakeholders, as well as the findings of previous research, there are significant compliance challenges. It is suggested that consideration should be given to the underlying causes of compliance shortfalls that have been identified. A review of credit agreements has revealed that disclosures contained in unsecured personal loan credit agreements have significantly improved with the implementation of the NCA. However, the layout, format, clarity and complexity of the language used in respect of the different credit provider agreements vary significantly. Some areas for development have been identified. Input provided by consumers during focus group sessions, as well as perspectives offered by industry experts during interviews, indicates that reckless lending is a factor that requires ongoing attention. The limited review of credit agreements that has been undertaken as part of the study indicates that the participating credit providers have developed procedures to assess affordability of consumers, but it is evident that these are not consistently formulated or applied across the credit providers in question. This is, to a large extent, a result of the limited regulatory specification or industry guidance relating to the nature, timing and extent of affordability assessments that must be carried out. It is suggested that consideration should be given to providing high level principle based guidance to credit providers. Rules based “one size fits all” regulation is not recommended at this juncture. Further research would be needed to determine the level of compliance with NCA requirements.
Cost of credit	Unsecured personal loans are generally written at prices that are higher than secured lending. This is due to a number of factors, the most important being the assessment of the risk relating to any particular loan as well as costs that are incurred by credit providers. Unsecured loans are not a full substitute for secured lending in that, due to their terms and conditions, they will not be appropriate for financing the entire spectrum of assets that are acquired by consumers. There is some degree of overlap and, to an extent,

Factor	Considerations
	unsecured personal loans are complementary to secured lending. A direct comparison of the costs between unsecured personal loans and secured lending products should be seen within the context of the respective product characteristics. The average cost of credit in respect of unsecured personal loans (Q3 2011) for the ten largest suppliers of unsecured personal loans was 23.5%. This compares to the cost of credit in respect of mortgages which is closely linked to the prime interest rate, 9% over the course of the study. The majority of the unsecured personal loans book is written at fixed rates, which is beneficial to the consumer in a rising interest rate market, i.e. their repayments will not increase when the repo rate increases (*visa versa* for a decreasing interest rate pattern). However, new loans would be subject to higher interest rate caps when rates increase. Although there is differentiated pricing across the market according to the size of unsecured personal loans granted, some credit providers price all their agreements at or near the margin, 32.1% at the time of conducting research. This appears to be due to their market positioning. It is suggested that regulatory requirements relating to the disclosure of cost of credit should be considered with view towards including the cost of credit life insurance. Further, it is suggested that disclosure of a "repayment multiple" which includes all costs will assist consumers in understanding the cost implications of credit taken up[4]. This will, in the light of the consumer focus on the installment payable as opposed to the components of the cost of credit, provide consumers with a valid basis on which to compare loans and understand the implications thereof.
Market practices	Credit providers are actively targeting unsecured personal loans as a business growth opportunity. Certain market practices indicate their business approach and consideration thereof would be of value from a consumer protection perspective, i.e. in the light of the benefits that are derived from having clear specification relating to practices that are acceptable bearing in mind that this should promote a level playing field. The following practices have been identified in this regard – zero percent loans (where no interest is charged and all revenue is derived from fees and credit life insurance), payment holidays (where repayments are suspended either at the outset of a loan or during the term thereof, but interest and fees will be charged, which means that increased amounts must be paid in future), certain aggressive advertising practices (where consumers are targeted with offers to

[4] **"**Loan repayment multiple**"** means the number times the total installments in respect of a loan exceeds the capital amount advanced.

Factor	Considerations
	take up credit, including cell phone sms offers) and credit bureau enquiries (where batch enquiry volumes have significantly increased which could, to an extent, be due to marketing activities). The aforementioned have elements that are unfavourable for consumers, particularly where the implications thereof are not understood, as well as elements that are favourable, e.g. where a payment holiday is provided to a consumer that is not debt stressed but will for a period not have cash flow to make payments. Other practices that require consideration are ATM and other loans that are applied for and approved electronically. Comprehensive consumer education initiatives that promote healthy consumer demand behaviour, will play a positive role from a consumer protection perspective.
Credit life insurance	Credit life insurance is a feature of the unsecured personal loans market. Credit providers generally require consumers to take out insurance, but allow the option of substituting their own policy. Credit life insurance premiums are a significant revenue stream and contribute some 11% (Q1 2012 statistics) to the overall revenue of credit providers in respect of unsecured personal loans. However, the indications are that mass market consumers do not generally obtain comparative quotes relating to credit life costs. To the extent that this is a feature across the industry, this will limit the level of competition in the market. It is suggested that enhanced disclosure of credit life insurance costs (as part of the cost of credit) and benefits to consumers will provide consumers with a clearer understanding of the overall cost of credit in respect of unsecured personal loans, as well as the features thereof. Credit provider staff that provide consumers with unsecured personal loans also sell credit life insurance to these consumers. In view of the overlapping regulatory / supervisory purview in this regard, benefit would be derived from integrated industry initiatives to address credit life insurance matters. It is understood that such initiatives are already in place.
Risk mitigation by credit providers	The credit providers that participated in the study have policies and procedures that address the regulatory requirements that fall within the ambit of the NCA and the supervisory scope of the NCR. They are able to provide a high level indication that they have implemented these. They have targeted unsecured personal loans in the light of the returns that can be made where the quality of lending books can be maintained at an acceptable level. The respective revenue streams that are generated, i.e. interest, fees, charges and credit life premiums provide an attractive business opportunity in the current market conditions. The level of overdue unsecured personal loan accounts is relatively

Factor	Considerations
	high in comparison to secured lending products, specifically mortgages and vehicle finance, however, this is, to an extent, expected in the light of the inherently higher risk profile of the unsecured personal loans. Credit providers and various industry stakeholders maintain that there is not an immediate threat to the safety and soundness of the financial system as a result of the recent strong growth in unsecured personal loans. Consideration of the aforementioned falls outside of the scope of the research study. However, it is logical that, at some point, where very high growth rates are maintained over an extended period of time, the level of credit granted through unsecured personal loans will be unhealthy. Past experience has shown that both credit providers and consumers are, at an overall industry level, prepared to grant and take up more credit than is sustainable and it is evident that the impact on consumers of overextended markets will remain a concern. This debate is linked to the recommendation to monitor the indebtedness of consumers at a macro level. It is submitted that as the unsecured personal loans market matures, the characteristics thereof will change. It is likely that margins could narrow and the implications thereof would need to be seen in the light of the level of overdues and other variables.
Level of indebtedness	The level of indebtedness of consumers can be measured at a micro level, e.g. when a loan is extended by a credit provider, or at a macro level using an appropriate measure, e.g. consumer surveys or industry credit health indicators. The industry level South African debt to income ratio at 74.7% in Q1 2012 is relatively high when compared to the pre-2004 picture, but has reflected an improving trend in recent years after peaking in 2008. The improvement is due to a gradual increase in incomes of households without this increase being fully leveraged into increased levels of debt. There are a number of industry level indicators of consumer credit health, which point towards an improving trend, although consumers remain vulnerable to potential adverse market conditions. There are a number of indicators of consumer credit health which point towards an improving trend, although consumers remain vulnerable to potential adverse market conditions. However, this picture is not clear-cut and certain statistics point towards industry level concerns relating to the level of indebtedness, particularly in the light of the significant number of consumers that have accounts that are impaired. From an individual consumer perspective, indebtedness is a function of a number of interrelated variables and it is suggested that benefit will be gained from regulatory / supervisory consideration thereof. In particular, principle level guidelines would improve credit provider understanding of the regulatory requirements in respect of affordability. Further, compliance by credit providers would be

Factor	Considerations
	improved where there is active supervision thereof in a manner that encourages a “level playing field” and consumer education initiatives will provide consumers with support needed in encouraging a robust understanding and appreciation of the implications of credit.
Access to finance	The variables that drive credit demand within the regulatory framework are dynamic and complex. Growth in unsecured personal loans plays a significant role in promoting access to finance for consumers. This product, in the light of the characteristics thereof, allows credit providers to price for risk, the maximum interest rate being 32.1% when the study was conducted and provides consumers with loans of up to R150k over terms, which are typically less than 60 months (with some indication that maximum amounts granted and terms offered will, to some extent, be increased going forward). Pricing has a direct impact on access to credit. For instance, where the interest rates that are charged to clients are reduced, there will be a reduction in access to finance to certain higher risk clients that could have been serviced by credit providers at those higher rates (provided that they could afford the repayments relating to the credit in question). Accordingly, any access to credit debate should include consideration of the impact that pricing regulation will have. This includes all aspects of price, including interest rates, fees, charges and credit life insurance. Access to finance is a function of the level of income of consumers. Importantly, all of the participating credit providers sell unsecured personal loans to consumers that are employed and have income levels that make the loans affordable. It is logical that unsecured personal loans will be provided to a greater extent where income levels are higher across the population that resides in any particular area. Consumers that take up more credit than they can repay are, to some extent, complicit in the over-indebtedness that arises. This could be due to a range of underlying motivations on the part of the consumer, including: lack of understanding of the implications credit, disregard for the consequences of over-indebtedness, “I want it and I want it now” attitudes to expenditure or asset acquisition and societal pressures that promote unhealthy credit behavior. It is submitted that further research into the micro and macro considerations that push consumers into over-indebtedness will be of value towards developing industry level guidance. The demand for credit across the broad base of South African consumers is evident. Where access to the formal market is limited via market regulation or through interest rate or fee caps, credit needs of consumers will be met through alternative sources, which could include loans from family members or the likes of “loan sharks”.

Factor	Considerations
Features of unsecured personal loans	In the light of the characteristics of unsecured personal loans, there are, in comparison to secured lending, less formalities and product complexity in taking up credit. The credit process, from application to granting of credit, can be completed within a relatively short period of time. The range of expenditure or asset acquisition that can be financed by unsecured personal loans has expanded somewhat with the increasing loan amounts that are offered by credit providers over terms that have been lengthened in recent years. It will be in the interests of consumers to take up unsecured personal loans in meeting credit demand, provided that the consumers would not have qualified for less expensive credit options, when it was appropriate to do so, but for some reason these were not available to them. This could be due to market conditions or the regulatory environment not favouring the provision of cheaper secured lending and credit providers opting to focus on more expensive unsecured credit products. It is suggested that consideration should be given to reviewing the strength of the relationship between the factors that make secured credit less attractive to credit providers and the unfavourable implications of constrained access to secured lending by consumers. Some industry commentators point to the level of indebtedness in South Africa and raise the question of what is driving South Africa's high indebtedness levels. Concerns relating to credit provider incentives relating to the treatment of the consumers with impaired records have been raised, as well as various market conduct matters that lead to over-indebtedness. The need to differentiate between the legal recourse of consumers from compliance enforcement has been identified, notably in respect of over-indebtedness and reckless lending. Over and above the legal implications relating to the aforementioned, benefits will be derived from a review the compliance of credit providers and the use of enforcement options to addresses instances of non-compliance. Increased resources would be required by the NCR to supervise compliance in this regard. Consumption expenditure that is financed through credit beyond levels that would be considered healthy results in an increase in the indebtedness of consumers and reduces future capacity of consumers to spend or acquire assets. This has been described as the promotion of a "hollow economy". This terminology is new and it is suggested that there would be merit in further consideration thereof by the NCR. The scope of the study has not extended to an evaluation of the level of satisfaction of consumers relating to unsecured personal loans. The factors referred to in the commentary above require further consideration. This could be addressed through research that is specifically designed to understand consumer behaviour in more

Factor	Considerations
	detail.
The effect if consumers use alternative methods of funding	The core variables that should be considered in evaluating the impact of unsecured personal loans on consumers from a cost of credit perspective are the capital amount advanced, costs (i.e. interest rate, initiation fees, services fees and credit life insurance) and the term of a loan. For instance, the bigger the capital amount advanced, the higher the amount of interest will be for any given interest rate. The higher the interest rate charged, the higher the cost to the consumer will be for a given loan amount. Extending the term of a loan will have the effect of reducing the amount of the periodic installments payable in respect a loan (typically paid monthly), but interest will be paid over a longer term, thereby increasing the cost of finance over the term of the loan in nominal terms. For example, for a loan of R10,000 (with an initiation fee of R650 and a monthly credit life payment of R63 and a monthly services service fee of R57) will have total installments for the 36 month loan which will total 2.1 times the initial capital amount of the loan (excluding capitalised costs), which is 0.6 times higher than a 12 month loan repayment multiple of 1.5 times. Where consumers require credit, they choose the credit products that are available from credit providers that suit their personal circumstances. This may take the form of secured credit, for instance mortgages for house acquisitions or installment credit in respect of the purchase of motor vehicles. Alternatively, consumers may choose an unsecured credit option, specifically where the purpose of the credit is not suitable for secured lending or they do not qualify for such credit. In view of the characteristics of unsecured personal loans, this product is clearly not a full substitute for secured lending, particularly in respect of mortgage advances. However, if it can be shown that unsecured personal loans have been taken up because mortgage finance was not extended to a consumer who would normally qualify for a mortgage, a comparison between the two products would be valid. Firstly, the interest rate that is offered in respect of unsecured personal loans would be relatively high, the average interest rate offered by the participating credit providers being some 23.5%, which compares to a typical rate of some 16% for loans in the region of R150k, as opposed to a 9% rate that could be obtained in respect of a mortgage. The total mortgage installments for a given amount advanced, say R150k, will be higher than the total installments in respect of an unsecured personal loan for the same amount, as a result of the lower monthly mortgage installment being repaid over a longer period of time (typically 240 months for mortgages in comparison to some 60 months unsecured personal loans). However, the borrower may pay more in real terms for the unsecured personal loan than for a mortgage, notwithstanding the longer term of the bond. The use of an unsecured personal loan to finance the acquisition of a

Factor	Considerations
	vehicle instead of a secured vehicle finance product, would, for the most part, be evaluated in terms of the interest rates offered, which will be typically higher in respect of unsecured personal loans, resulting in higher monthly installments.
Use of credit	In view of the size and term of unsecured personal loans offered by credit providers, they would not be large enough or taken out over a long enough term to finance the acquisition of formal housing or expensive motor vehicles, however, they could be used for low cost housing, property extensions, paying a deposit on a house and education costs. The aforementioned could be classified as “wealth creation” purposes. On the other hand, consumption related credit extension would include household consumption expenditure and costs relating to social family commitments. Some credit provided could be consumption or wealth creation purposes. This will depend on the circumstances, for example vehicles and furniture could be used to generate income if the assets in question are used in a business or could be for personal use by the consumer, i.e. consumed over the life of the asset. Credit providers do not generally take into account the consumer’s credit usage (underlying purpose in taking out a loan) in making credit approval decisions. In other words, whether the credit that is obtained is for consumption or wealth creation purposes is, in general, not directly relevant to the credit assessment process that is undertaken by credit providers. This is understandable in that unsecured personal loans are extended to consumers without consideration of any underlying asset that may be acquired for security purposes. Unsecured personal loans are used for both wealth creation and consumption purposes. Statistics obtained from credit providers for Q3 2011, the “building and renovations” usage category reflects a relatively large component of the total at 23% of credit granted for the quarter. The amounts advanced to consumers are, to a large extent, made up of smaller balance loans, with over half thereof with lower than R30k advances. This could be an indication that the loans are being used for informal housing or that relatively inexpensive building or renovation costs are being incurred. Debt consolidation (internal and external) is a significant feature of the market. This constitutes some 27% of the credit granted during Q3 2011. This study has, to a large extent, relied on the analysis of credit usage furnished by credit providers. A full analysis of the usage of credit by consumers may reveal further information that could be used in informing the development of policy.

Each of the factors that are highlighted above are addressed in more detail in the respective sections of the full report that has been prepared.

A representative of one of the credit providers mentioned that making changes to credit market regulation or the supervision thereof “is a lot like making changes to ‘Rubik’s Cube’”. This is perhaps a colourful way of describing the interrelationships between the supply and demand factors that are relevant to the debate relating to the high growth in unsecured personal loans, but it is a useful representation of the challenges faced. Where changes are made to an aspect of the regulatory or supervisory requirements, these could have an impact on various aspects of the credit market, some intended and some unintended (much like making changes to Rubik’s Cube).

This is illustrated by the apparent reluctance of banks to grow their mortgage books at rates that compare to the growth rates of their unsecured lending books. One of the drivers of this credit supply dynamic is the introduction of payment system changes that are designed to level the playing field between banks and other credit providers – This, together with various other factors, has made secured lending less attractive from a business sustainability perspective, as described in part of this report.

The strong growth in unsecured personal loans is impacting the level of indebtedness of consumers and is changing the shape of the market, with a trend which reflects larger loans being offered over longer periods.

In summary, the following high level recommendations are put forward for consideration by the NCR. These are made in the light of the findings of the research that has been undertaken into unsecured personal loans, but aspects thereof could be relevant across the board to all products / business that falls within the ambit of the NCA.

Consumer study:

Various opportunities have been identified for consumer related studies. These include consumer credit behavior, credit demand analysis, consumer focus on installments as opposed to the cost of credit, credit usage and monitoring of the level of unsecured lending against consumer indebtedness.

Consumer education:

Consumer education initiatives that are designed to encourage healthy consumer credit behaviour and a sound understanding of the implications of credit will provide consumers with valuable support in promoting behaviour that will lead to improving levels of indebtedness.

Supervisory investigation:

The monitoring or inspection of credit providers (offsite as well as onsite), with the focus on both large and smaller organisations, will provide the impetus for improving levels of compliance with regulatory requirements. It is submitted that the governance of credit providers should serve as a point of departure in this regard.

Credit market:

Further consideration of various aspects of the credit market will provide perspectives that will inform the development of policy, notably in respect of total cost of credit disclosure (including credit life), affordability guidelines, structural disincentives for credit providers to provide secured credit (particularly mortgage loans) and the implications of consolidation loans and multiple loans to consumers.

3 CONCLUSION

This report has been prepared in order to record the findings of a limited scope research assignment that has been undertaken by Compliance & Risk Resources. This document is seen as a work in progress that serves as a platform from which to further investigate factors that are relevant in understanding the high growth that has been reported in respect of unsecured personal loans.

In conclusion, the following observations are made:

- It is advisable to differentiate between “financial system” and “consumer protection” implications of the growth in unsecured personal loans. This will encourage a dialogue that focuses on the ambit of the NCA within the supervisory purview of the NCR;
- Benefit will be derived from the development of a definition and understanding of consumer credit health at a macro level in South Africa, i.e. from the perspective of the level of indebtedness of consumers at industry level as well as other relevant factors;
- The majority of unsecured personal loans are advanced to consumers that are vulnerable to changes in economic conditions and should conditions deteriorate in the current uncertain environment this could have a significant impact on “consumer credit health”. These consumers may also be vulnerable to events that could impact each consumer individually, for example a life event such as severe illness;
- Unsecured personal loans have encouraged access to credit, but with this increased access to credit there is some trade off between the level of overdues and the access that is facilitated by this product;
- A significant amount of unsecured personal loans are written at the margin, i.e. at or close to the interest rate cap of 32.1%. Such lending is typically advanced to higher risk customers, who will perhaps most benefit from the NCA requirements. It is suggested that monitoring of business that falls into this category will provide perspectives needed to understand the effectiveness of consumer protection measures in the light of the market dynamics.
- The relatively high level of consumers with impaired accounts with credit bureaus is a concern. The level of consumers with impaired credit records requires consideration;
- There has been constrained growth in mortgages over the last year as a result of numerous interrelated factors that have contributed to the attractiveness of mortgage business being eroded. Benefit would be derived from further investigation into the structural considerations that have contributed to the relatively low growth in secured lending in recent years;
- The current high growth in unsecured personal loans will raise increasing consumer credit sustainability questions if this is perpetuated over an extended period of time. Although the market is expected to mature which will moderate the returns that can be made by credit providers, the current relatively high margins have made this product attractive and growth rates have not yet slowed;

- A robust segmentation of both credit providers and consumers will facilitate improved analysis and communication across the industry in respect of both the supply and demand for credit;
- There will be benefit from explicit differentiation between the focus on the laws that protect consumers (legal perspective) and credit provider compliance considerations (that can be supervised in the protection of credit providers). Notable, the NCR has limited capacity for review of credit providers and enforcement of compliance across the broad base of credit providers; and
- Further consumer related research is needed to analyse credit demand factors that have been identified.

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TERMS AND ACRONYMS USED

A brief definition of key terms used in this report is set out below:

"**Credit health**" is a measure of a consumer's capacity to meet debt commitments taking into account the consumer's current income and expenditure levels and the consumer's reserves that can be used where expenditure or income levels deteriorate, as well as indicators of consumer credit wellness.

"Credit life insurance" includes cover payable in the event of a consumer's death, disability, terminal illness, unemployment, or other insurable risk that is likely to impair the consumer's ability to earn an income or meet the obligations under a credit agreement[5].

"**FAIS**" means the Financial Advisory and Intermediary Services Act.

"**Financial stability**" means the joint stability of the key financial institutions and the financial markets in which they operate[6].

"**GDP**" means gross domestic product.

"Loan repayment multiple" means the number times the total installments in respect of a loan exceeds the capital amount advanced.

"NCA" means the National Credit Act No. 34, 2005.

"NCR" means the National Credit Regulator.

"**Participating credit providers**" means the ten largest providers of unsecured personal loans that provided research statistics and participated in interviews and meetings over the course of the research project.

"**Reckless credit**" means the credit granted to a consumer under a credit agreement concluded in circumstances described in section 80 of the NCA.

"Unsecured personal loans" (UPL) means loans which are repayable over a period of time in installments, where there is no security that the credit provider can rely on to recover their debt if repayments are not made.

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5 Section 1 of National Credit Act No. 34, 2005.

6 South African Reserve Bank. http://www.resbank.co.za. Referenced 25 June 2012.