



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

FINAL REPORT

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Prepared For:



INDEX

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

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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 stability¹:

“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 purpose² 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 NCR³, 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	<p>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.</p> <p>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.</p> <p>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.</p> <p>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</p>

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
	<p>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.</p>
<p>Compliance with applicable NCA requirements</p>	<p>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”.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>Further research would be needed to determine the level of compliance with NCA requirements.</p>
<p>Cost of credit</p>	<p>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.</p> <p>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,</p>

Factor	Considerations
	<p>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.</p> <p>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.</p> <p>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 (<i>visa versa</i> for a decreasing interest rate pattern). However, new loans would be subject to higher interest rate caps when rates increase.</p> <p>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.</p> <p>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 up⁴. 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.</p>
Market practices	<p>Credit providers are actively targeting unsecured personal loans as a business growth opportunity.</p> <p>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</p>

⁴ “Loan repayment multiple” means the number times the total installments in respect of a loan exceeds the capital amount advanced.

Factor	Considerations
	<p>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.</p> <p>Comprehensive consumer education initiatives that promote healthy consumer demand behaviour, will play a positive role from a consumer protection perspective.</p>
Credit life insurance	<p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p>
Risk mitigation by credit providers	<p>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.</p> <p>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.</p> <p>The level of overdue unsecured personal loan accounts is relatively</p>

Factor	Considerations
	<p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p>
Level of indebtedness	<p>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.</p> <p>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.</p> <p>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</p>

Factor	Considerations
	<p>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.</p>
<p>Access to finance</p>	<p>The variables that drive credit demand within the regulatory framework are dynamic and complex.</p> <p>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).</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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”.</p>

Factor	Considerations
Features of unsecured personal loans	<p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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</p>

Factor	Considerations
	detail.
The effect if consumers use alternative methods of funding	<p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>The use of an unsecured personal loan to finance the acquisition of a</p>

Factor	Considerations
	<p>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.</p>
<p>Use of credit</p>	<p>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.</p> <p>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.</p> <p>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.</p> <p>Debt consolidation (internal and external) is a significant feature of the market. This constitutes some 27% of the credit granted during Q3 2011.</p> <p>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.</p>

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 5.3 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 RESEARCH METHODOLOGY

3.1 Introduction

While much of the focus and research effort has been on obtaining information from credit providers, relevant credit supply and demand factors have been identified from input received during interviews, meetings and workshops held with a range of industry stakeholders as well as a limited number of focus group interventions.

A desk based review has been undertaken and structured questionnaires / materials have been used in respect of credit provider input, consumer focus groups and interviews with industry experts. These have been developed in consultation with the NCR.

The research that has been undertaken has provided a robust foundation on which to inform the NCR in respect of factors that should be taken into account when assessing the strong growth in unsecured personal loans.

Key aspects of the approach that has been applied are set out below.

3.2 Desk based review

Research that is relevant to the current study has been identified. Relevant matters contained therein have been considered as a point of departure in respect of the current study into the growth in unsecured personal loans.

3.3 Credit providers

The ten largest providers of unsecured personal loans were selected to take part in the study based on the information submitted in their Form 39 submissions to the NCR. A listing of the providers that furnished specified statistics and information relating to their unsecured personal loans books is set out in the table below:

Figure 3 – Table showing credit providers that participated in the study

Credit Provider	Description
ABSA Bank Limited	Large bank
African Bank Investments Limited	Predominantly unsecured lending bank
Bayport Securitisation (Pty) Ltd	Micro lender
Capitec Bank Holdings Limited	Predominantly unsecured lending bank
FirstRand Bank Limited	Large bank
Nedbank Limited	Large bank
Old Mutual Finance House 1 (Pty) Ltd	Insurance owned micro lender
RCS Personal Finance (Pty) Ltd	Micro lender

Credit Provider	Description
Sanlam Personal Loan (Pty) Ltd	Insurance owned micro lender
Standard Bank Limited	Large bank

Each of the selected credit providers was asked to complete a questionnaire covering key aspects of the supply of credit, specifically in respect of:

- Credit policies and procedures applied by credit providers;
- Affordability assessment;
- Cost of credit; and
- Credit market practices.

The participating providers also furnished a statistical analysis, which served as a basis on which to analyse key aspects of the unsecured personal loans market. This contained information relating to the income levels of the consumers that are provided with credit as well as the size, term and performance of their unsecured loans books. Information relating to the usage of credit was also obtained.

Further, meetings were held with each of the providers to discuss their submission of information / statistics. This provided a platform from which to obtain a sound understanding of the unsecured personal loans market.

3.4 Pre-agreement statements and quotes

The ten participating credit providers were asked to select 30 clients for which unsecured personal loans have been provided and forward the following to the NCR for research purposes:

- Pre-agreement disclosure statement / quotation and credit agreements relating thereto;
- Record of the affordability assessments that have been carried out.

Providers were requested to select the abovementioned in a manner that does not introduce sample bias and cover an appropriate range of consumers, taking into account demographics, income levels, as well as loan sizes that are granted. This encompassed agreements entered into during the period 1 June 2011 to 31 December 2011.

A review of the credit agreements selected by credit providers was undertaken in order to obtain an understanding of the approach adopted in respect of affordability assessment as well as various aspects of compliance relating to pre-agreement statements / quotes and agreements entered into.

A sample of some 300 credit agreements across the ten participating credit providers was requested. This is not statistically relevant at an industry level and the results of the review should not be used to draw conclusions about the overall status of the credit industry. The objective of the review is to highlight practices that may require consideration by the NCR from a regulatory or supervisory perspective. Further research would be required in order to determine the extent of market practices identified.

3.5 Consumer focus groups

In view of the study timelines and other constraints, desk based research relating to credit demand considerations has been the research focus. However, this has been supplemented by two consumer focus group discussions that were held in order to identify the consumer related considerations that may require further analysis going forward. Each of the participating consumers was asked to complete a questionnaire and discussion relating to the respective sections thereof was facilitated.

It is noted that consumers that fall within the target market were identified with the assistance of the following organisations: Kudough Credit Solutions (Pty) Ltd and the National Debt Mediation Association. The consumer selection process was designed to highlight factors that are relevant to understanding the growth in unsecured personal loans.

The consumers selected are not, by design, representative of the South African market from an income level, geographic spread or other criteria. The output from the focus group sessions cannot be used to draw conclusions about the South African credit market in general, however, read together with the findings of other studies / research, various factors have been identified for consideration by the NCR.

3.6 Interviews with industry experts / stakeholders

A number of interviews with industry experts were held in order to gain a robust understanding of the drivers relating to the supply of and demand for credit.

The following interviews were held:

- Bob Currin, AfricaScope;
- Carel Van Aardt, BMR;
- Rob Geffry, Econometrix;
- Stephen Logan, Logan Attorneys; and
- Tjaart van der Walt.

Broad industry level contributions towards understanding the South African credit market in respect of unsecured personal loans have been made by the aforementioned. These have been considered in the light of input provided by representatives of the participating credit providers and industry associations as well as regulatory authorities that have participated.

3.7 Industry workshops

Industry workshops have been held with regulators, supervisors, and industry associations. The workshops held and the participants involved therein are described in the table below:

Figure 4 – Table showing industry workshops held

Description	Participants
Regulators	Representatives from the Financial Services Board, Bank Supervision Department of the South African Reserve Bank, National Treasury
Banking Association of South Africa (BASA) – 2 workshops	BASA staff members as well as representatives from banks
Industry Associations	Representatives from NDMA, CPA, MFSA and the FAIS Ombud
Credit Bureaus	Representatives from the respective credit bureaus

The above has allowed for debate relating to features of the credit market. Importantly, the workshops encouraged dialogue that has facilitated communication across a wide range of stakeholders.

4 CREDIT MARKET ANALYSIS

4.1 Introduction

This section of the report contains a description of relevant aspects of the credit market with a view towards providing the context against which to consider the growth in unsecured personal loans.

Market conditions that are relevant to the study have been identified together with factors for consideration when evaluating the health of the credit market. The status of the credit market should be viewed in the light of the prevailing economic circumstances in the country. Further, the impact of changes in the economy that can be expected in future could influence the behavior of credit providers and consumers. These are highlighted with a view to identifying matters that should be considered by the NCR.

4.2 Desired market conditions

Consideration should be given to the market conditions that will support the supply of credit in a manner that meets demand in the interests of consumers. Key factors that should be evaluated in assessing the South African market in this regard include the following:

- Healthy suppliers;
- Healthy competition, between credit providers and sectors;
- Informed consumers;
- Effective regulation;
- Effective supervision; and
- Improving credit health of consumers.

In terms of the perception of contributors to the study, the South African market represents a sound platform for the supply of credit, which, in some respects, requires further development. A number of challenges relating to the demand for credit have also been identified.

Credit providers that achieve healthy credit growth and adequate profit generation as well as retention of sufficient reserves in the light of the risks that they face will be in a sound position to operate in an uncertain economic environment going forward. Further, providers that offer varied product offerings with an appropriate mix that addresses consumer credit needs should be encouraged. The indications are that the provision of reckless credit will require ongoing attention - One of the cornerstones of the regulatory framework is the requirement to assess affordability of consumers when they apply for credit.

The study has, in terms of its scope, focused on the larger suppliers of unsecured personal loans. However, a review of the smaller credit providers may yield further perspectives that will be relevant in this regard.

Healthy competition, between credit providers and sectors is desirable, where there are a variety of suppliers and market segments / niches, broad geographical footprint of suppliers and access to funding for smaller credit providers that can achieve a scale of operations that allows for efficient delivery.

Consumer education that promotes an environment where consumers are well informed about the implications of credit is recognised as a valuable contribution towards sustainability. Informed consumers that understand the implications of becoming over-indebted are central to encouraging a healthy credit market. Although numerous information and education initiatives have been undertaken by various industry stakeholders, the indications are that there are challenges in achieving real changes in consumer behaviour in some segments of the market, i.e. in the light of the number of consumers that enter the debt review process or have impaired records at credit bureaus.

It is evident that opportunities for consumer education interventions across a broad base have been recognised by the authorities that supervise the credit market as well as credit providers that have an interest in the continued health thereof, i.e. from a sustainability perspective.

Effective regulation of the market is fundamentally important. The NCA is in place and its provisions are being addressed by credit providers and other stakeholders in their compliance therewith. As is the norm with the implementation of new regulatory requirements, it takes time for those impacted by them to develop effective systems and process needed. A number of practical challenges have been identified in the implementation of the NCA requirements. These are addressed later in the report. They are being considered by the NCR for the purpose of addressing any gaps, legal uncertainties or loopholes therein.

Effective supervision is crucial to the achievement of regulatory objectives from a credit supply perspective. Laws that are brought into effect without supervision will typically translate into a relatively low level of compliance therewith. The credit market supervisor, the NCR, has been established and its consumer protection mandate has been put in place. There are, however, a number of supervisory considerations that are still being developed which will depend on the level of resources available, notably in respect of the monitoring or inspection of credit providers as well as focusing to a greater extent on the smaller credit providers.

The credit health of consumers is crucial to the transformation and development of South Africa. This is a complex and multidimensional debate, aspects of which are considered below. Where there is increased employment, which translates into improving household debt to income ratios, this will indicate a favorable outlook for consumer credit health. However, there are numerous variables that should be considered. Importantly, the substantial level of impaired credit performance reflected at credit bureaus is a concern. Other statistics relating to credit health should also be evaluated, for example the number of consumers that enter the debt review process. It is noted that the credit burden of consumers is a sub-set of the overall financial burden of consumers. Credit health is inextricably linked to numerous factors that should be seen holistically.

4.3 Monetary policy

The current low interest rate pattern, with a 30 year low in the repo rate, has favourably impacted credit active consumers, i.e. as a result of relatively low interest charges in the current environment.

It is anticipated that interest rates will increase in future. This will, to a large extent, be driven by market circumstances, which will be outside of the control of the South African authorities.

Depending on the extent of the increases, this could have a significant impact on consumers that have variable rate credit agreements or consumers that take out new credit agreements in the higher interest rate pattern. Although the majority of unsecured personal loans are written as fixed rate agreements, the effect of interest rate increases will, over time, lead to a general increase in the cost of credit for consumers.

It is recommended that anticipated increases in interest rates should be monitored and the impact thereof, at a macro level, evaluated from the perspective of obtaining information that will be relevant to understanding the likely effect on the indebtedness of consumers.

4.4 Savings incentives

The level of household savings is relevant to the debate relating to demand for credit. Where consumers require funds to acquire assets or meet expenditure, these will, in general, be sourced from savings or alternatively obtained through credit from credit providers.

The question of whether South African consumers are incentivised to save requires some consideration. Various industry stakeholders that provided input towards the study indicated that consumers do not generally have a savings culture. This is evident in the low South African gross savings levels as a proportion of GDP.

The aforementioned is, to an extent, driven by savings products not being able to generate returns to be sufficiently attractive to consumers to generate behavior that supports a savings culture. Where returns do not keep up with inflation, consumers will, in all likelihood, not have the financial incentive to invest their money in products such as savings accounts or fixed deposits. However, fixed rate RSA Retail Savings Bonds are a

notable opportunity where returns are relatively high. The level of income of consumers that will not be consumed and will be available for savings purposes could be monitored together with the interrelationship thereof with the demand for credit.

4.5 Regulatory requirements

A number of factors that should be considered in evaluating the strong growth in unsecured personal loans have been identified from a regulatory requirements perspective.

For instance the regulated interest rate formulae as well as the account initiation and service fees have remained unchanged over the last 5 years. This has, to an extent, made the granting of unsecured personal loans attractive to credit providers in that margins in this product are relatively high, i.e. making up for fee levels that have remained static.

Some contributors to the study have pointed out that “over-regulation” of the credit market is a concern and that, to the extent that this is happening, it is counter-productive. There are numerous requirements over and above the NCA that impact credit providers, including the Financial Advisory and Intermediary services Act (FAIS) and the Financial Intelligence Centre Act (FICA). The dispersed nature of the respective regulatory requirements as well as the supervision thereof, means that compliance responses by credit providers may not be efficient and could result in industry communication challenges.

Further, Basel III requirements that are scheduled to be brought into effect will, in particular, have a significant impact on banks, specifically where increased levels of capital must be held in respect of their liquidity positions.

Certain laws have resulted in credit providers exhibiting conservative lending strategies in respect of various lending products, particularly in respect of mortgages. For instance, ambiguous regulatory requirements and debt review challenges have had a significant impact.

Supervision of the financial services industry is expected to evolve and develop over time. For example, the so called “twin peaks” approach will, in terms of current plans, provide a platform which is likely to lead to improved communication and integration opportunities relating to the cross section of supervisory responsibilities. Enforcement powers of supervisors are crucial to compliance by regulated entities. There are resources and other restraints that will pose challenges in respect of the aforementioned considerations.

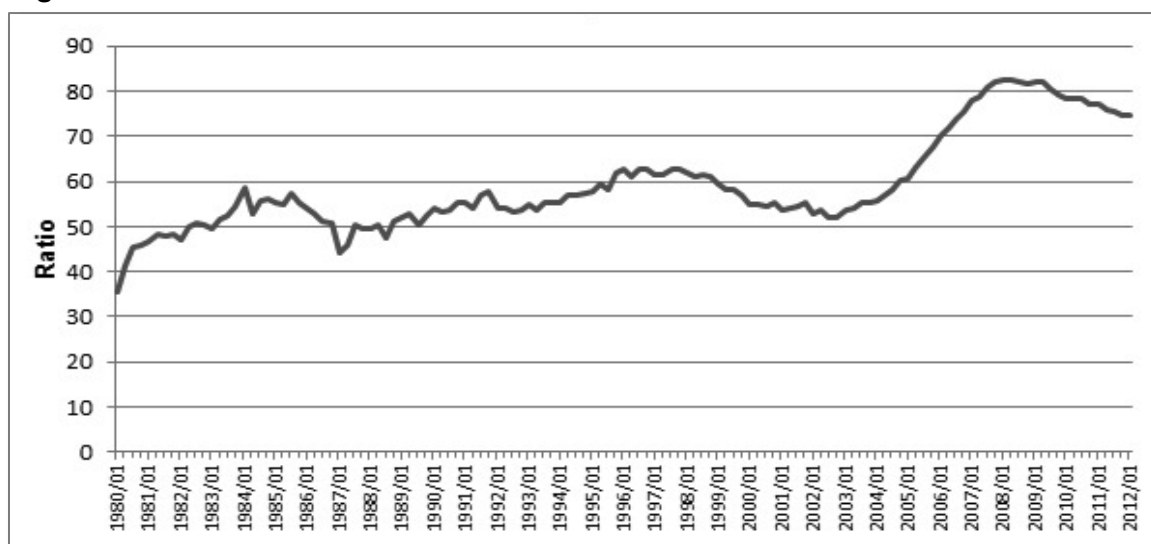
4.6 Level of indebtedness

An assessment of the level of indebtedness of South African Consumers will provide a backdrop for the evaluation of the increasing growth in unsecured personal loans. Where consumers have relatively high debt levels, the growth in unsecured personal loans to any particular segment of the credit market that is already “indebted” or has the potential to become over-indebted, may be seen to be compromising the consumers in question.

An increasing level of indebtedness is one side of the equation when considering whether this will, from a consumer credit health perspective, be sustainable. Specifically, this should be seen in the light of the level of income generated by consumers. The capacity of consumers to service their debt commitments in future is central to this debate.

The South African debt to income ratio provides relevant perspectives in this regard.

Figure 5 – Debt to income ratio



Source: SARB

As illustrated in the graph above, the debt to income ratio rose steadily over the period Q1 2004 (55.9%) to Q1 2008 (82.7%), whereafter the ratio is now on a downward trend and is recorded at 74.7% in Q1 2012. This is still relatively high when compared to the pre-2004 picture, but is an indication that the credit health of consumers is improving, i.e. relative to the picture shown in 2008.

The improving debt to income ratio is to a large extent a result of a gradual increase in incomes without this increase being fully leveraged into increased levels of debt over the period Q4 2008 to Q1 2012.

The question of whether the current debt to income levels are appropriate for South African circumstances requires some consideration, i.e. in the light of the increase in the ratio from pre-2004 levels.

It should be recognised that the recent improvement in the debt to income ratio has, however, to a large extent, been supported by the current low interest rate pattern. Consumers have benefitted from relatively low rates, which could, in future, increase thereby increasing the debt repayment commitments of consumers across a broad base. The extent of this increase will depend on numerous variables, including economic conditions in South Africa as well as internationally. Monetary policy aimed at inflation targeting will play a significant role. There are numerous, interrelated and complex factors that could significantly impact of interest rates in future.

Credit that is extended to consumers provides an opportunity to achieve a standard of living that would not be possible in its absence, but, on the other hand, where consumers are overstretched and across a broad base are not able to meet their debt commitments for any reason, this will adversely affect their financial prospects going forward. A significant section of the South African credit market is vulnerable to changing economic conditions and the level of indebtedness should be monitored to facilitate an appropriate understanding of the macro indicators in this regard.

It is noted that the debt to income ratio described above is considered to be a “blunt instrument” in that there are numerous interrelated variables that have varying degree of relevance at a national level. These include the level of inflation, the type or mix of debt that is taken up, term of the debt, interest rate patterns and income levels.

Although the debt to income ratio reflected in the graph (*Figure 5 – Debt to income ratio*) reflects an improving ratio, this picture is somewhat different in a credit provider that has provided input relating to consumer debt, income and installment levels, i.e. where the indications are that consumer unsecured personal loan installment levels are rising faster than the consumer income levels. This could be due to the specific nature of the credit provider input as opposed to the generic nature of the national level statistics.

Benefit would be derived from the development of a model that is appropriate for tracking debt, income and debt installment levels in South Africa, i.e. with a view towards understanding the implications thereof for the credit market.

4.7 Economic conditions

Increasing levels of credit that have been extended should be seen against the backdrop of relevant economic indicators.

For instance, as stated in the Statistics SA⁵ publication on the South Africa Consumer index, “the headline CPI (for all urban areas) annual inflation rate in February 2012 was 6,1%. This rate was 0,2% of a percentage point lower than the corresponding annual rate of 6,3% in January 2012. On average, prices increased by 0,6% between January 2012 and February 2012”. Future CPI changes will have an impact on consumers where these translate into cost of living increases.

Living expense increases that are likely to place consumers under financial pressure in future can be identified, for example the recent relatively high increases in fuel prices could have a significant impact on household expenditure.

The SARB has published the following in respect of GDP growth⁶: “In South Africa growth in real gross domestic product accelerated to an annualised rate of 3,2 per cent in the final quarter of 2011 as activity in the mining and manufacturing sectors recovered, following two quarters of decline induced by factors such as industrial action, mining fatalities and safety inspection shutdowns”. The following was also published: “Among the domestic expenditure components, real household consumption expenditure

⁵ Statistics SA. Statistical release P0141. Consumer Price Index February 2012. Release date 18 April 2012.

⁶ South African Reserve Bank. Quarterly Bulletin - No 263. March 2012.

continued to expand briskly. After a slight hesitation in the middle quarters of 2011 its pace of increase picked up in the final quarter as consumption expenditure continued to track growth in real disposable income. The lower interest rate environment was supportive of household consumption expenditure, along with the gradually declining level of household indebtedness which had receded from more than 82 per cent of annual disposable income in 2008 to less than 76 per cent at the end of 2011. Spending on durable goods remained the strongest-growing category within overall household consumption expenditure, recording double-digit rates of increase throughout 2011.”

The above provides insights into key features of the South African economy at the time the study into the high growth in unsecured personal loans was conducted. This is not exhaustive and is intended to highlight that ongoing monitoring of the macroeconomic environment will provide valuable perspectives in understanding the credit market going forward.

A large portion of the unsecured personal loans is being made to lower and middle income consumers. For instance⁷, some 65% of the credit granted during Q3 2011 was to consumers that have a gross monthly income of less than R15k. A further 27% was granted to consumers that have a gross monthly income of more than R15k but less than R30k. Consumers in these income categories are inherently vulnerable to changes in economic conditions in South Africa. They are impacted by increases in living expenses and may be subject to uncertain revenue streams when economic conditions deteriorate.

The above picture is also evident in the profile of consumers that enter the debt review process. For instance, DCASA⁸ has indicated that a sample of credit agreements for consumers that applied for debt counseling showed that some 66% of the agreements were in respect of consumers that had an income level of less than R10k (some 42% in respect of rand value of agreements), while 27% had an income of more than R10k but less than R20k (some 39% in respect of rand value of agreements).

One of the core messages that has come out of the research that has been conducted into the growth in unsecured personal loans is the crystallisation of the realisation that business planning should be undertaken within a purview that sees “through the economic cycles”, perhaps most importantly for credit providers in respect of the pricing of credit that is granted.

South Africa is impacted by global economic conditions. A forward looking evaluation of the South African economy should take into account anticipated developments in other markets, for example the current uncertain European Union prospects, the recovering USA economy as well as conditions seen in the so called BRIC economies. Consideration of the impact of changes in global economic conditions is advisable when evaluating the South African market.

It is evident that the South African financial system and credit market in general performed relatively well in comparison to the global markets referred to above following the financial crash in 2008. Further, credit providers have, throughout the course of the

⁷ NCR statistical information. Q3 2011.

⁸ DCASA. Consumer Debt Stress Presentation. 16 February 2012.

study, supported by representations made by both Bank Supervisions Department of the South African Reserve Bank and the Banking Association of South Africa, indicated that the growth in unsecured personal loans does not represent a threat to the financial system.

Whether or not this growth represents a so called “bubble” at this time is beyond the scope of the study. However, it is advisable that the factors that would indicate that consumer interests would be threatened should be monitored and evaluated. Where regulatory / supervisory responsibilities overlap, this will be benefits from appropriate consideration thereof to the advantage of the safety and soundness of the financial system as well as consumer protection variables that fall within the ambit of the NCA.

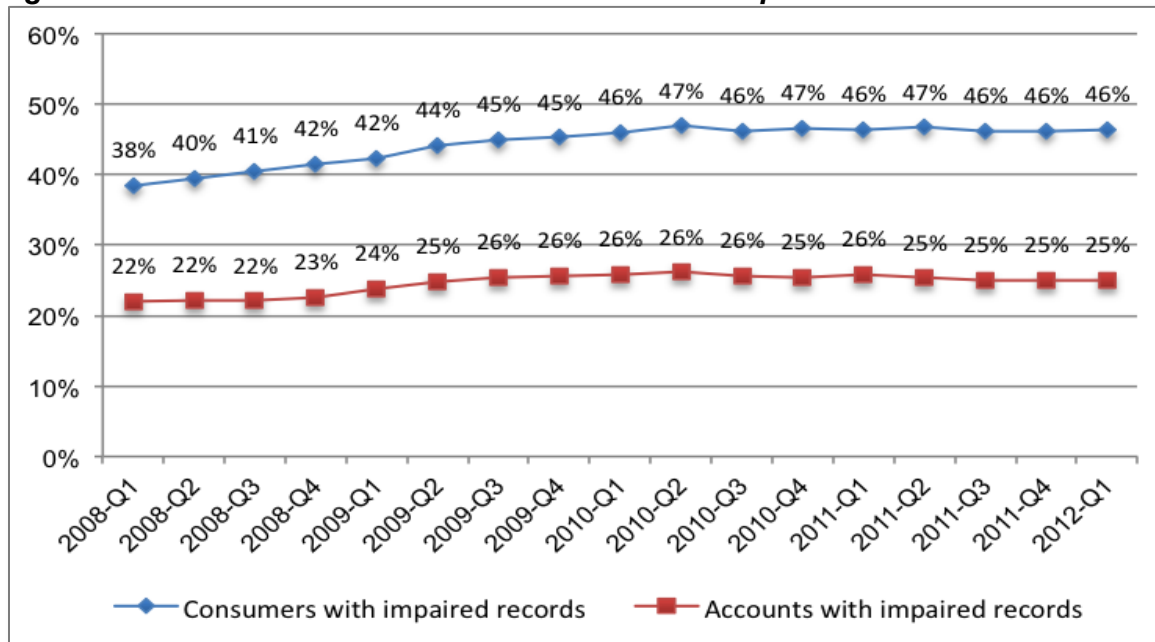
In the final analysis, if the causes and effects of market bubbles are understood, this begs the following question: Why have there been regular crashes throughout history? Based on what has happened in the past, it is likely that another financial crash will eventuate. In this regard, the question of who is responsible for understanding the factors that will cause this, from a credit market perspective, should be addressed.

4.8 Impairment of consumer records

It has been reported that a significant number of credit active consumers have impaired records at credit bureaus (i.e. where their accounts have been more than three months in arrears). This statistic, if accurate, is an indication of the vulnerability of the credit active population to not being able to continuously meet credit commitments.

The graph that is set out below illustrates the increasing level of consumers with impaired records over the period to Q2 2010 (46.9% with impaired records) and reflects a consistent sideways movement at this level thereafter.

Figure 6 – Level of consumer records and accounts impaired



Source: NCR data obtained from credit bureaus

It is noted that the Q1 2012 proportion of consumers with impaired records, 46.4%, has been calculated based on a reported 9.1 million consumers with impaired records (consumers with accounts more than 3 months in arrears) out of a total credit active population of 19.5 million. The proportion of accounts that are impaired, 25%, has been calculated based on a reported 16.9 million accounts more than 3 months in arrears out of a total of 67.5 million.

The above picture is considered to be conservative by banks that have participated in the study as a result of various factors, including differences in the data obtained from credit bureaus and duplication in certain statistics. For example, it has been represented that the proportion of clients with accounts more than three months in arrear is some 38% as opposed to 46%. The debate relating to this matter is perhaps a good illustration of the different perspectives against which the credit market can be viewed. From a financial stability perspective, the primary focus will be the rand value of loans that are “deeply impaired” as this will be a reflection of write-off that may be needed. On the other hand, from a consumer protection perspective, the core focus will be on the number of consumers that are debt stressed or over-indebted.

It is recognised that a consumer may only have one account that is three months in arrears and that other accounts may be up to date and that credit providers may still be willing to provide the consumer with further credit, although this may be at a relatively high interest rate. However, from a “credit health” standpoint, this is a valid indicator. Credit health, as addressed in more detail later in this document, should be seen from a consumer perspective and not from a credit provider viewpoint.

The table that is set out below illustrates the proportion and number of consumers that have accounts three months or more in arrears using data provided by the Banking Association of South Africa as a base, i.e. in respect of the percentage impairment, which has been used to determine the number of consumers in each category.

Figure 7 – Analysis of consumers with impaired records

Impairment	Proportion of Credit Active Consumers with Impaired Records⁹	Number of Consumers with Impaired Records
Impaired but recovered	8.3%	1,6m
Impaired partially	6.6%	1,3m
Impaired recently	4.0%	0,8m
Impaired deeply	18.7%	3,6m
Total consumers with impaired records	37.6%	7,3m

Source: Banking Association of South Africa

⁹ Banking Association of South Africa. Analysis of the level of debt of South African Consumers. April 2012.

Although the Rand value proportion of deeply impaired records will be significantly lower than the 18.7% of consumers with such records, the number of consumers is significant, 3.6m.

It is submitted that the underlying drivers of the statistics referred to above should be considered and the need for ongoing monitoring thereof determined.

During a meeting held with representatives from industry associations, it was indicated that often “no one is at fault” when consumers are unable meet their loan repayment commitments. For example, a consumer could lose their job and not be able to obtain another one. On the other hand, certain practices that are applied by credit providers contribute to the level of indebtedness of consumers. This is indicated in previous studies that have been carried out as well as input provided during consumer focus groups held during the current project. Further, it is submitted that consumers themselves are, in some cases, complicit in overextending themselves through the uptake of credit which is beyond their means to repay.

An investigation, at a macro level, of the underlying causes of over-indebtedness will provide perspectives that will be of value in informing policy relating to the regulation and supervision of the credit market.

It is clear that the financial burden of consumers involves factors that extend beyond credit consumption, i.e. financial commitments over and above the need to make repayments relating to credit extended, for example costs relating to housing utilities or cell phone accounts. This should be viewed in a holistic manner in order to obtain a broad understanding of the market. It is submitted that factors that impact consumers (particularly consumers that are most vulnerable to changing market conditions) should be monitored.

4.9 Debt review

Challenges relating to the debt review process are relevant to the consideration of the growth in unsecured personal loans. All credit providers interviewed have indicated that debt review considerations have had a major impact on their lending strategies.

Notably, it is evident that the process, to a far greater extent than in the past, favours unsecured lending as opposed secured lending. This has had the effect of incentivising credit providers to constrain their lending in respect of home loans, which has contributed to the increase in supply of unsecured personal loans over the review period.

Various industry stakeholders have expressed concern relating to the number of consumers that have entered the debt review process. However, in the light of the number of consumers that have accounts that are impaired, as described in part 4.8 above, the question should perhaps be “why are there not more people in debt review?”.

It is noted that the implications of the debt review process with payments via PDAs requires some consideration in assessing the credit market.

4.10 Consumer credit health

In broad terms, “credit health” can be described as a measure of a consumer’s capacity to meet debt commitments taking into account various factors, for instance:

- Current credit commitments;
- Income and expenditure levels;
- Reserves available to cushion against unforeseen unfavourable events; and
- Credit wellness criteria.

The above goes further than the “reckless lending” requirements specified in the NCA, in terms of which credit providers must assess the affordability of credit before entering into a credit agreement with a consumer.

Affordability assessment is undertaken on a case by case basis at the time of granting of credit by credit providers. If credit providers effectively undertake affordability assessments, it can be reasoned that, at the time of providing credit, consumers have adequate income sources to repay debt commitments in question. This may, however, not necessarily take into account circumstances that may change over time, either in respect of an individual consumer, or in respect of economic conditions in general. Credit health of consumers can be measured at a micro level for any particular consumer or at a macro level for consumers in general.

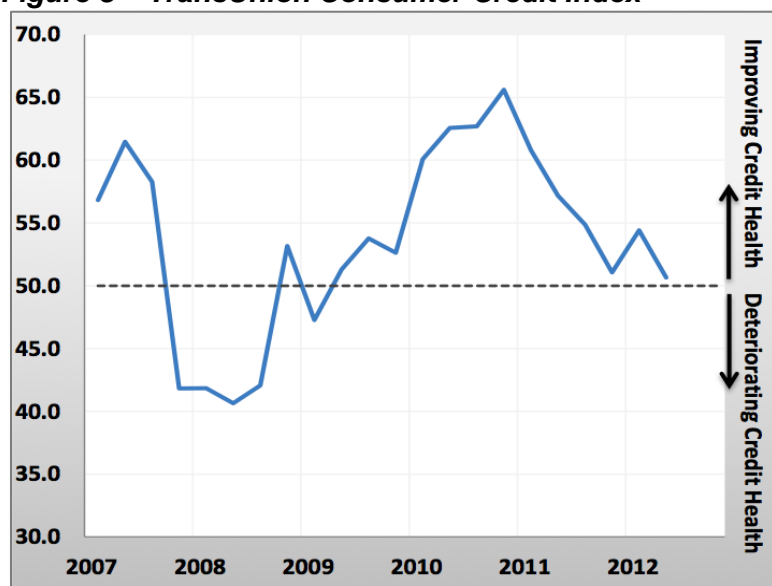
The effectiveness of the measures taken by credit providers to address reckless lending will depend on numerous factors, for instance systems, processes and controls implemented and maintained by the credit provider. Other factors will include the regulatory requirements relating thereto, i.e. in the light of the clarity thereof and the manner that they can be applied towards the achievement of the objectives of regulatory requirements in question.

A number of perspectives of credit health are considered in the commentary below. These indicate that the credit health of consumers is improving. This compares with the picture shown in the debt to income ratio described in section 4.6 of this report, which shows an improving level of consumer debt in comparison to income levels. However, it is important to recognise that this improvement has been recorded during a time where South African interest rates have been kept low and the international uncertainties in Europe and other markets have not, at this juncture, translated into major economic fallout for South Africa.

TransUnion consumer credit index

TransUnion publishes a “SA Consumer Credit Index”, which is derived from TransUnion data comprising 50% of the final credit index and from non-TransUnion data making up the other 50%. This provides an indication of the credit health of consumers, which refers to the ability of households to service existing debt repayment costs from monthly budgets.

Figure 8 – TransUnion Consumer Credit Index



The index “measures the aggregate consumer loan repayment record, tracks the use of revolving consumer credit facilities as an indicator of distressed borrowing, estimates household cash flow as a means of determining financial pressure/relief, and quantifies the relative cost of servicing outstanding debt. These aspects are then combined into a single indicator of credit health”.

Source: TransUnion

The above graph¹⁰ reflects a strong improvement in consumer credit health in 2010, followed by a steady moderation in the index back toward the ‘breakeven’ level in 2011. At the start of 2012 there was an increase in the index, but this has been reversed in the Q2 2012 TransUnion report.

There may be some risk that, although consumer credit health improvement indicators are now at a breakeven level, there is a risk of the index declining below 50.0, which will indicate declining consumer credit health.

Distressed household borrowing rates remain a cause for concern. This is, to an extent, an indication of the inherent vulnerability of certain segments of the market.

The variables that are used in the derivation of the TransUnion index are dynamic in nature and will change over time. The tracking thereof would provide valuable information relating to the credit health of consumers.

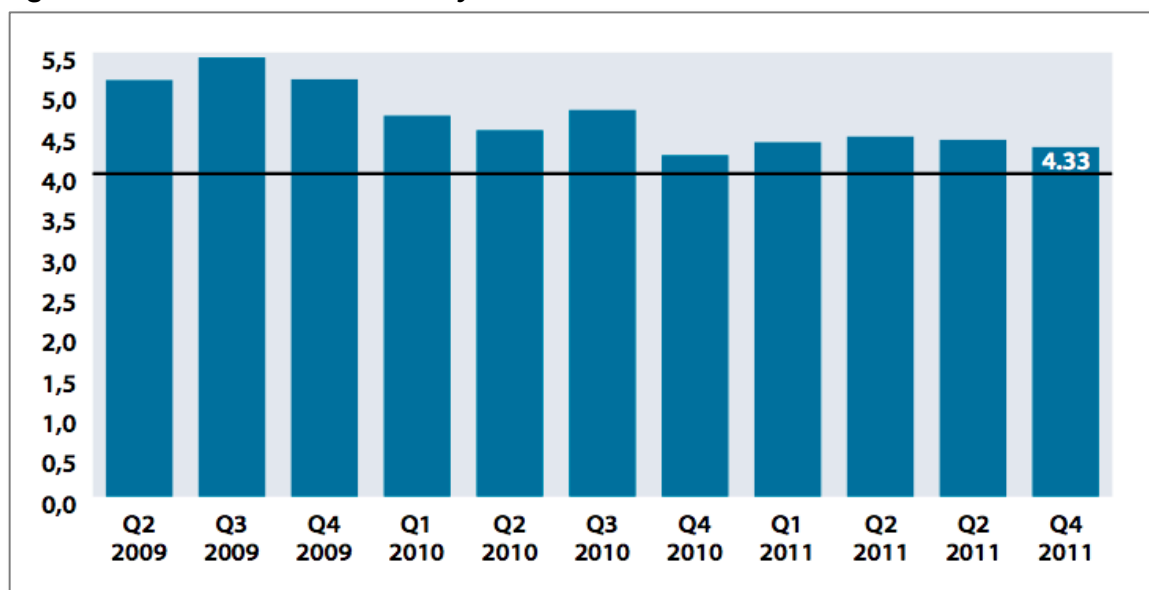
Consumer vulnerability index – UNISA BMR

UNISA publishes a consumer vulnerability index. This is used as an economic indicator of consumer perception and feelings about the four broad financial categories that impact their lives, namely income, expenditure, savings and the ability to service debt¹¹.

¹⁰ TransUnion SA Consumer Credit Index. High Level Overview. 28 February 2012.

¹¹ UNISA Bureau of Market Research. Consumer Financial Vulnerability Index. Quarter 4 2011.

Figure 9 – Consumer vulnerability index



Source: UNISA Bureau of Market Research

The index that is derived is read against the following scale.

CFVI Categories	Scale
Financially very secure	0 to 1.9
Financially secure	2.0 to 3.9
Somewhat financially vulnerable	4.0 to 5.9
Financially very vulnerable	6.0 to 7.9

Source: UNISA Bureau of Market Research

Where the index is 4 or higher, this represents that consumers are somewhat financially vulnerable or financially very vulnerable. The above graph shows that the overall index has remained above the 4 level (above the line drawn therein). The graph reflects an improving debt servicing vulnerability trend, although there is some volatility in the index. However, the Q4 2011 index, at 4,33, still shows that consumers are still somewhat financially vulnerable.

It is noteworthy that the best performing component of the index is debt servicing vulnerability category. This has, over the last 2 quarters, dropped below the 4 threshold.

Momentum / UNISA household financial wellness index 2011

The Momentum / UNISA household financial wellness index is a measure of household financial wellness based on a holistic assessment of variables such as household net wealth, household income and expenditure, the household environment, its level of social empowerment / connectedness and level of education of primary earners in households.

The index is determined with a view to categorising consumers according to their financial wellness. The categories and descriptions thereof are set out below.

Figure 10 – Momentum / UNISA financial wellness categories

Category	Description
Anchored Unwell	This means that the household is deeply rooted in an unwell position with very little likelihood of being lifted from such a position without major outside assistance.
Drifting Unwell	The household is not deemed to be entrenched in an unwell position. However, its position is unstable and negative circumstances can easily cause the household to become anchored in an unwell position, whilst a positive influence can move the household into the Drifting Well category.
Drifting Well	As is the case with the Drifting Unwell household, the Drifting Well household's situation is unstable. It can easily become Drifting Unwell, but may also move toward the Anchored Well position with assistance.
Anchored Well	The household is financially firmly well.

Source: Momentum / UNISA household financial wellness index 2011

This study currently indicates that¹² “the majority of South African households are in the ‘Drifting Unwell’ category making them most vulnerable to adverse economic developments such as interest rate increases, inflation pressures and any loss of income”.

The above reveals that, although a number of indicators of consumer credit health have moved positively, the majority of consumers are exposed to changes in economic circumstances and will be materially impacted if these change adversely.

4.11 Credit providers

In analysing the credit market, it is useful to categorise different credit providers, as illustrated in the listing below.

- Traditional Bank;
- Predominantly Unsecured Lending Bank;
- Large Micro-Lender;
- Retail Lender;
- Small Lender;
- Unregistered; and
- Informal.

¹² Momentum / UNISA household financial wellness index. Conducted by Personal Finance Research Unit & Bureau of Market Research, College of Economic and Management Sciences. 2011.

Credit providers have differing organisational structures, governance needs, regulatory / supervisory requirements, funding structures, product offerings, as well as varied business strategies in addressing the credit demand of consumers.

Where credit providers are seen in the light of a well structured credit provider categorisation, this would encourage an appropriate view of the challenges of each segment thereof and promote improved communication between industry stakeholders. An example that illustrates the aforementioned is over-indebtedness in consumers that are not in full time employment, i.e. it would not be appropriate to conclude that credit all providers are responsible for this situation in that this market is generally not serviced by the banks or larger micro-lenders. The category of credit providers that supplies credit to unemployed consumers should be addressed in this regard.

From an unsecured personal loans pricing perspective, it is evident that some credit providers reflect a wide range of pricing in respect of unsecured personal loans, i.e. in the light of the risk posed by different consumers, while other credit providers generally write all business at the margin, i.e. at or close to the current 32.1% interest rate cap. It is also clear that different credit providers have differing approaches to dealing with clients as well as differing challenges in protecting their reputations or standing in the market. The pricing of all loans at the margin may not be a concern in that all of a particular credit provider's business may be to high risk clients that are not serviced by banks. Accordingly, it is useful to understand the specific characteristics of each credit provider in evaluating their business models.

The aforementioned will include the scale of operations of credit providers including their geographical footprint. For instance, where they have limited business volumes, e.g. a small micro lender, they will not typically be able to benefit from economies of scale, which will tend to result in higher cost of delivery for the credit provider, thereby leading to limited opportunity to pass on the benefits of efficiencies to consumers in terms of lower pricing. Increasing business operating costs (e.g. salaries, rentals, advertising, infrastructure costs) in the current uncertain economic environment will have an impact of credit providers, i.e. in the light of their particular business models, and thereby impact the pricing of their lending products.

Smaller credit providers may have less access to funding and the cost thereof may be relatively high, specifically where the organisation's risk profile (credit, interest rate, liquidity, operational, compliance and other risks) is relatively high. The risk management frameworks of different organisations, as well as the sophistication thereof, differs significantly across different types of credit provider.

All of the credit providers that participated in the study make use of automated credit assessment systems and processes. These are described by the respective participating credit providers as effective in managing their credit risk. On the other hand, smaller credit providers often rely on manual risk assessment and mitigation solutions, which may be less effective, notably where market conditions change or in an environment where dynamic risk management tools are needed.

Credit providers are motivated by business motives. They conduct business in an uncertain environment and in order to be sustainable they need to generate an adequate return on investment / equity for their investors / shareholders. Where a credit provider is able to achieve this, their cost of capital / funding will tend to be reduced going forward.

Further, funding sources for credit providers are limited from local and foreign sources if their business profile is not attractive to funders.

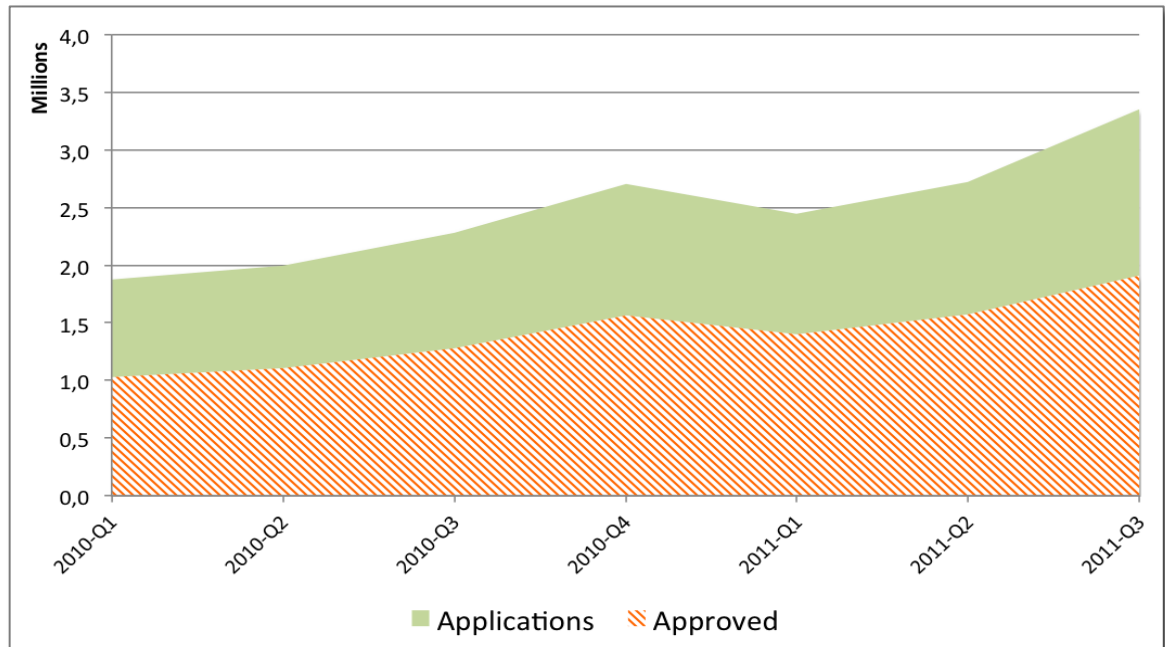
Market practices may be different for the respective credit provider categories. For instance, the study has not revealed concerns relating to a bank's use of "pin and card practices", i.e. where the credit provider keeps a consumer's autobank card and obtains their pin number to withdraw funds for repayment purposes, whereas input from various stakeholders indicates that this practice still takes place in the "informal sector".

Credit providers indicate that it is essential to have a level playing field from a regulatory requirements perspective. The cost and complexity of complying with the applicable requirements is often highlighted as a matter for concern by credit providers, particularly where the regulatory requirements are not uniformly applied across the industry. Requirements relating to affordability assessment are cited as an example in this regard, i.e. there is limited specification or guidance as to how this should be conducted. Over-regulation of the credit market has been raised as a matter that requires attention.

4.12 Consumers

The demand for credit is evident in the growth reported in unsecured personal loan applications made, as illustrated in the graph below.

Figure 11 – Loan applications made in comparison to loans granted



Source: NCR request for statistical information from ten participating credit providers

The level of loan approvals in the above graph has tracked the growth in applications made. The ratio of approvals to applications made has increased over the last year from 55% in Q4 2010 to some 57% in Q3 2011. This is, in the light of the increased focus on the supply of credit through unsecured personal loans, expected, however, the increase is not, at this juncture, materially out of line with past trends.

Different consumers have different credit demand needs and, for the purposes of this research, should be viewed within the context of thereof. Understanding of their credit health would be enhanced where categorisation of credit providers allows for analysis in the light of appropriate consumer segmentation.

This can be done using various criteria, i.e. income levels, demographic, geographic, psychographic, or credit usage. The use of LSM levels in categorising consumers is appropriate for credit market analysis purposes, which could serve as a foundation for evaluating key aspects of the demand for credit. Opportunities in this regard have been recognised by the NCR, i.e. consumer categories could be developed according to credit relevant criteria, which could serve as a basis to improve consideration of their particular credit characteristics. Appropriate descriptors of each category will provide opportunities for improved communication.

The FinScope¹³ study shows that the consumer profile (in respect of consumers that have unsecured personal loans) has changed in recent years. This is illustrated in the table that is set out below, which analyses the composition of the unsecured lending market over the period 2008 to 2011.

Figure 12 – Analysis of unsecured lending market

LSM Group	2008	2009	2010	2011
Total loans	5 317 050	5 913 817	4 585 261	8 236 033
LSM 1 to 5	47%	47%	34%	34%
LSM 6 to 7	36%	37%	41%	46%
LSM 8 to 10	17%	16%	25%	20%

The pattern by LSM group suggests that the lower end / mass market usage of personal loans has declined from 47% down to 34%, whereas the so-called emerging market of LSM 6 and 7 has increased from 36% to 46%. The trend in the upper LSM groups (8 to 10) indicates an increase from 17% to 20%. The increase in the emerging market segment has increased the capacity of these consumers to access the credit from credit providers.

It is noted that, for the purposes of the research carried out, analysis of consumer credit granted according to income levels has been considered. This has, in order to obtain input from credit providers, been viewed from the perspective of the following income bands: R0-R3k, >R3k-R3.5k, >R3.5k-R7k, >R7k-R15k, >R15K-R30, >R30-R45k, >R45K-R60, >R60K –R100k, and more than R100k.

The apparent lack of understanding of the implications of credit commitments by some consumers is of concern. This has been indicated during consumer focus group sessions held. This could be due to the knowledge levels of these consumers in concert with inappropriate consumer decision drivers, which contribute to unhealthy credit

¹³ FinScope, a FinMark Trust initiative, is a nationally representative study of consumers' perceptions on financial services and issues, which creates insight to how consumers source their income and manage their financial lives.

uptake. These include the likes of “wanting to have the consumer goods such as TVs or other such equipment” where the consumer buys on credit but does not have adequate reserves in case something “goes wrong”.

Further, there are indications of the so-called “don’t want to know” consumer behavior. This has been described by consumers as the take-up of credit by consumers without proper consideration of the risks that go with the credit in question.

In the light of the above factors, it is recommended that segment appropriate education, starting at school level, will play a valuable role in supporting consumers. There is an opportunity to promote a culture where consumers are encouraged to live within their means.

The monitoring of consumer behaviour with a view understanding the underlying drivers thereof would provide valuable information regarding credit market dynamics.

There is some indication from data available from the FinScope study by Finmark Trust that consumer perceptions of banks (positive consumer descriptions of them include the following: “I trust them”. Negative consumer descriptors of them include the following: “The interest/bank rates and charges are too high”) are more positive than their perceptions of smaller organisations such as cash loan businesses (negative consumer descriptors of them include the following: “The interest/bank rates and charges, premiums are too high; Thieves; I don’t trust them/unreliable/nuisance; It’s bad/bad service”) as well as “mashonisas” (negative consumer descriptors of them include the following: “Thieves; The interest/rates and charges, premiums are too high; It’s bad/not good; I don’t trust them/unreliable/nuisance; I don’t like it”).

It would not be appropriate to see the above generic views as being those of all consumers that obtain loans from the respective credit providers. Clearly, a person that falls into a high income category who has a mortgage with a rate at below prime as well as an unsecured personal loan with an interest rate of 3% higher than prime may have a very different perception of the credit provider to someone that falls into a low income category who requires the loan for “living / survival” purposes and has a rate of 32.1% (interest rate cap that was applicable during the study) especially where the “headroom” between income and expenses is relatively small and affordability of repayments is a challenge.

There has been a gradual increase in income from growth in formal employment as well as increases in salaries and wages levels, which has supported the growth in lending that has been reported, specifically in respect of unsecured personal loans. However, there is a significant level reliance for the unemployed, or semi- /part time employed consumers on the informal market. This is, to an extent, understandable in terms of the NCA affordability requirements. Credit providers may not lend recklessly, i.e. they must assess a consumer’s level of income and expenditure and make an assessment thereof. It is reasoned that where income levels are not high enough or stable enough to sustain the consumer’s level of expenditure, a credit provider will not be in a position to lend to the consumers due to the compromised position they will face in respect of enforcement of the credit agreement in question.

At one extreme, where consumers that are not employed and do not have any sustainable source of revenue, it would not be realistic to expect them to be able to

repay any loan that is extended to them. Where a consumer has limited or uncertain revenue sources which do not leave much surplus revenue after expenses have been accounted for, this will make affordability a challenge for the consumer, as well as make the assessment of affordability by credit providers particularly important. Such consumers will tend to be relatively high risk and will generally attract higher interest rates, which could be at or close to the margin (current interest rate cap of 32.1%). At the other end of the affordability continuum, consumers may have a substantial surplus of income over expenses and could have a healthy affordability assessment, which could result in lower pricing from credit providers in the light of the risks that they pose. The income levels of consumers do not, in themselves, necessarily indicate the level of risk of a consumer.

As motivated in this report, it is important to appropriately segment the consumer credit market in order to analyse the impact of lending to any one component thereof. This is illustrated in the profile of consumers that have taken up unsecured personal loans as reflected in the FinScope study, which covers a sample of the “entire adult population, rich and poor, urban and rural, in order to create a segmentation, or continuum, of the entire market and to lend perspective to the various market segments”. The following features of the overall market have been identified¹⁴: There is a skew towards unsecured loans taken up by black female consumers that are single. The majority of unsecured loans are granted to the lower LSM group (1 to 5) and emerging LSM group (6 and 7) and there is a bias towards younger borrowers, less than 34 years old. Financially excluded consumers are informally served, specifically in respect of consumers that are not working or are unemployed, work part-time in the formal and informal sectors, a student or a seasonal worker currently unemployed. The education level of consumers with unsecured personal loans tends to be some high school or primary school education completed, or some primary school education completed, or no formal education. At the lower end of the market the source of money is often from a family member or from grants like child and disability grants.

An appropriate segmentation of consumers and a detailed analysis of each segment would yield valuable perspectives in understanding the demand for credit.

4.13 Payment system

Payment system developments have had a significant influence on the business activities of credit providers. Specifically, Naedo, which seeks to do away with preferential collection systems and requires that transactions presented for payment must be randomly presented. This has changed the priority with which collections are made. Value will be received once the account holder has sufficient funds in their account and once a Naedo transaction has been processed it cannot be unpaid.

Credit providers have indicated that the Naedo features referred to above have resulted in unsecured lending being favoured over secured lending in that secured lending repayments, in general, tend to be larger than unsecured lending repayments. This means, where a consumer does not have sufficient funds to meet all commitments, it is more likely that the larger secured lending repayments will be missed simply because of their size, while it is likely that a smaller unsecured lending repayment will go through.

¹⁴ Analysis of FinScope data undertaken by Bob Currin, AfricaScope.

It is noted that all credit providers that participated in the study indicated that they make use of Naedo.

5 CREDIT MARKET STATISTICS

5.1 Introduction

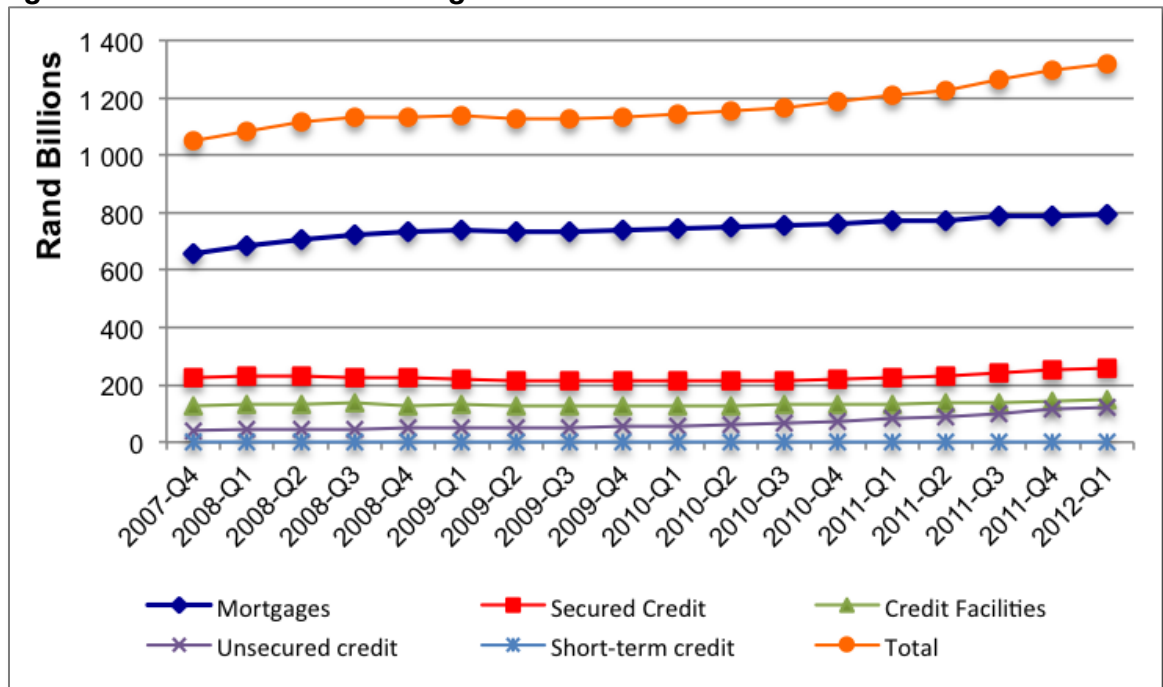
This section contains an analysis of the growth in lending in the South African market, which provides the context within which to analyse the recent growth in unsecured personal loans.

5.2 Analysis of lending statistics

The high lending growth rates recorded by credit providers preceding the financial crash in 2008 proved to be unsustainable. The implications of the global economic meltdown has brought the need for appropriate regulation and supervision into sharp focus, specifically where market conditions indicate that credit exposures are building up towards unhealthy levels for consumers.

The need for research into unsecured personal loans growth was recognised by the NCR in the light of the high growth reported by credit providers in respect of credit granted as well as the significant increase in the gross debtors balances of credit providers.

Figure 13 – Gross debtors book growth



Source: NCR

As can be seen from the above graph, this recent increase in total lending (as recorded in terms of statistics maintained by the NCR, is, to a large extent, due to an increase in the “unsecured credit” category, which includes unsecured personal loans.

The composition of the total South African lending book is shown in the table set out below. This indicates that the dominant lending category remains mortgages which, in respect of Q1 2012, constitutes R796.3bn of total lending of R1,320.9bn.

Figure 14 – Gross debtors book: Rand billion

Category	2009 -Q1	2009 -Q2	2009 -Q3	2009 -Q4	2010 -Q1	2010 -Q2	2010 -Q3	2010 -Q4	2011 -Q1	2011 -Q2	2011 -Q3	2011 -Q4	2012 -Q1
Mortgages	740.5	734.2	736.6	741.0	746.0	749.0	755.4	760.7	769.9	773.4	768.0	791.1	796.3
Secured Credit	220.8	214.2	212.1	212.0	211.6	215.0	215.3	221.7	226.3	229.0	240.6	250.0	255.6
Credit Facilities	129.7	127.0	128.0	125.1	129.2	129.1	129.7	131.9	133.0	135.8	138.0	141.3	147.3
Unsecured Credit	49.0	49.2	51.9	54.6	57.3	61.1	66.2	73.8	80.9	88.0	101.1	113.0	120.8
Short-term Credit	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.8	0.9	0.9

Source: NCR

The recent strong growth recorded in the unsecured personal loans book, 53.1% y-on-y to December 2011, and the somewhat constrained growth in mortgages as well as secured credit, 4.0% and 12.8% y-on-y to December 2012 respectively, has resulted in unsecured personal loans share of the total lending book increasing from 6.2% to 8.8% over the year. The high growth in unsecured personal loans has continued into the first quarter of 2012, with growth of 6.9% (annualised 27.7%), although at a slightly lower growth rate than that recorded during 2011. The unsecured personal loans Q1 2012 book is some R120.8bn, 9.2% of the total gross debtors book, compared to the mortgage Q1 2012 book of R796.3bn, 60.3% of the gross debtors book. This reflects the current trend where unsecured personal loans component of the overall book is growing at the expense of mortgage advances. This is represented in the graph set out below:

Figure 15 – Composition of gross debtors book



Source: NCR

The above graph shows an increasing mortgages book as a percentage of overall lending subsequent the financial crash in 2008, followed by a declining trend from Q4 2009, to a large extent as a result of the relatively strong growth in unsecured credit.

Whether this growth in unsecured personal loans will represent a sustainable consumer credit exposure across a broad spectrum of the consumers that make use of this product will depend on numerous interrelated factors. These are summarised in the executive summary in section 2 and addressed in various sections of the body of this report.

One of the considerations at the center of the debate is whether the current relatively high unsecured credit growth rates can be expected to continue going forward. Notably, there is currently no indication of a slowdown in the lending statistics that are supplied by credit providers.

5.3 Factors contributing to constrained mortgages growth

As illustrated in the analysis set out above, there has been constrained growth in mortgages over the last year to Dec 2011 (4.0% increase in the gross debtors balance), which has persisted into the first quarter of 2012. There are numerous interrelated factors that have contributed to the attractiveness of mortgage business being eroded. These include:

- Depressed property market values, which currently has limited potential growth in loan to value ratios, as well as constrained ability of homeowners to sell their properties should this be required by them - This may change in future, but currently makes mortgages less attractive to credit providers;
- Costs relating to bond origination, which have become a feature of the South African market, where bond originators charge credit providers a fee for originating mortgage business;
- Administratively intensive process with related costs in respect of writing mortgage business, including property valuation and legal mortgage formalities;
- Difficulty in realising security where credit providers experience challenges in evicting tenants;
- A debt review process that has contributed to delays and costs of realising security relating to mortgages, i.e. in a manner that does not favour secured lending, as well as increased losses in the event of default where properties are sold;
- Low margins and circumstances which do not currently allow for repricing of the existing book when economic circumstances change, for example a fixed invariable price 20 year contract with limited scope to reassess and re-price for current and changing risk profiles;
- Legal uncertainty in respect of some regulatory requirements, for example section 103(5) requirements relating to limits in respect of interest, fees and charges which can be levied following default by a credit provider, specifically in respect of legal uncertainty relating to the application thereof;
- Basel III requirements that are scheduled to be introduced in future will have the effect of further reducing margins where higher capital requirements are imposed; and

- Credit providers do not, in the current market conditions, in view of the implications of the recent market crash, generally provide 100% loans, which means that consumers will be required to provide the deposit required before being granted mortgage advances, thereby limiting the number of consumers that can get over this credit approval hurdle.

All credit providers that were interviewed as part of the study have stated that the market factors set out above have had a significant impact on their incentives to write mortgage business. An analysis of the extent of the impact is beyond the scope of the current study and it is submitted that further research should be conducted in to provide insights with a view to understanding the dynamics relating thereto with respect to unsecured personal loans and other forms of credit.

The analysis carried out shows that the pricing of mortgages is well below the maximum permitted by the NCA, which, at the time of preparing this report is set at 17.1%. It is interesting that, as a result of the structure of the credit market, the indications are that credit providers do not intend to increase prices relating to home loans. It is reasoned that in a market that is not competitive, credit providers will tend to raise prices as far as possible where consumer demand builds up.

The analysis that has been carried out has focused on the formal housing market from a mortgage advance perspective. There is clearly a need to consider consumer demand in respect of the informal sector. This is characterised by an environment where there will typically not be title deeds and the funding that is required will not be obtained through secured lending products.

6 UNSECURED PERSONAL LOANS

6.1 Introduction

This section of the report contains an analysis of the growth in unsecured personal loans and highlights key features thereof.

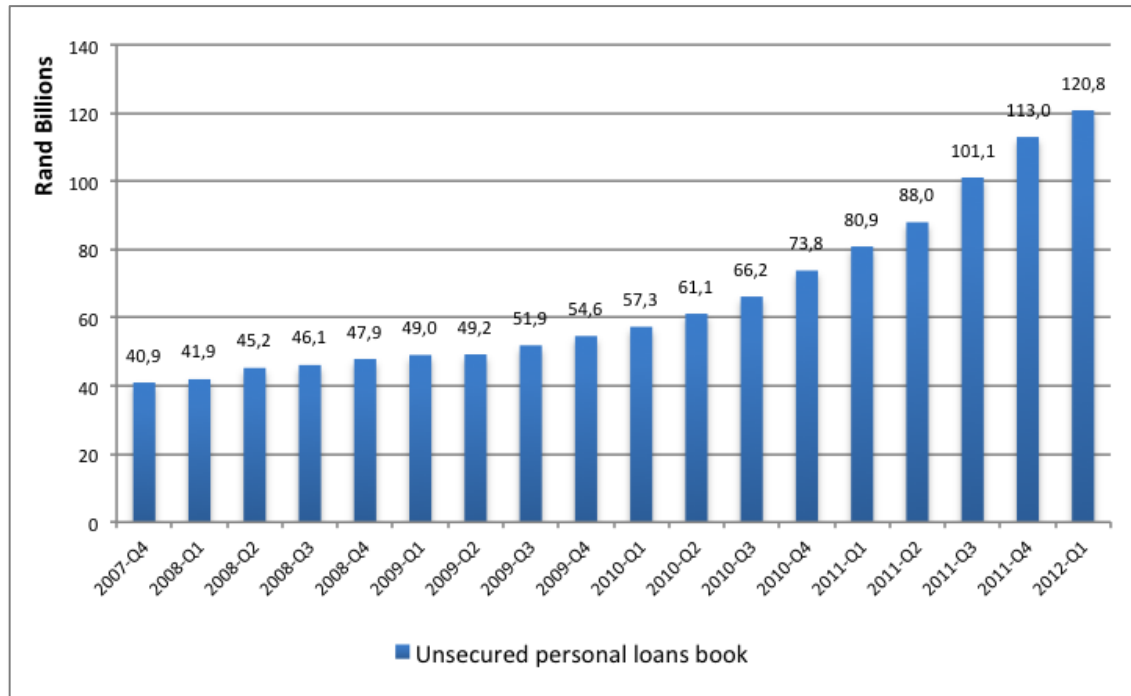
A listing of the unsecured personal loans book balances was obtained from the NCR and this was used to select credit providers that took part on the study - The credit providers with the ten largest unsecured personal loans books were selected in this regard. It is noted that the market for unsecured personal loans is dominated by 5 credit providers, which account for some 89% of the total industry loan book. Accordingly, the study has involved credit providers that supply the majority of the unsecured personal loans in the credit market.

The analysis that is set out below has been developed using input provided by the ten participating credit providers.

6.2 Unsecured personal loans book

Statistical information that has been received by the NCR (statistical returns from credit providers) indicates that credit granted in respect of unsecured personal loans has grown strongly over the last two years. The graph that is set out below tracks the quarterly growth in the total gross debtors book.

Figure 16 – Growth in unsecured personal loans gross debtors book



Source: NCR

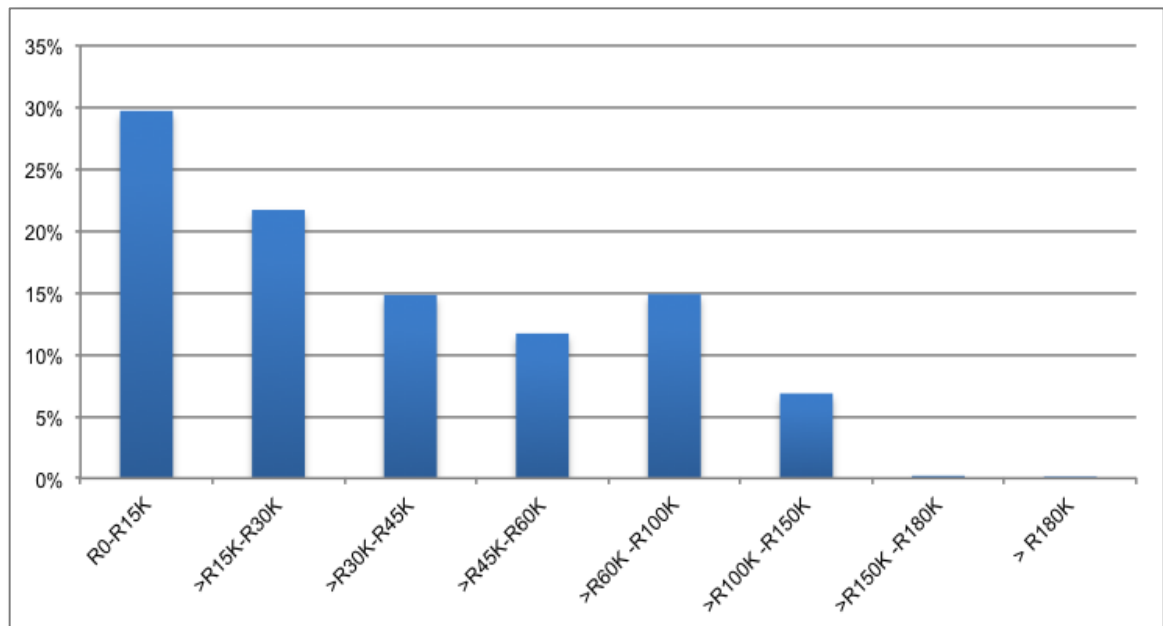
The high growth in unsecured personal loans over the year to Q1 2012, R40bn or 49.4%, has meant that a significant portion of the overall credit growth that has taken place has been in a relatively high cost product. Although this growth has been off a small base, it is recognised that the contribution to overall credit growth by unsecured personal loans now exceeds that of mortgage advances, R26.4bn or 3.4% over the year to March 2012.

6.3 Unsecured personal loan agreement sizes

The majority of unsecured personal loans granted have loan size agreements of less than R45k. September 2011 statistics show that this segment makes up some 66.3%, i.e. R15.9bn out of R23.4bn granted.

The composition of total credit granted (Q3 2011 statistics) according to loan size categories is illustrated in the graph set out below.

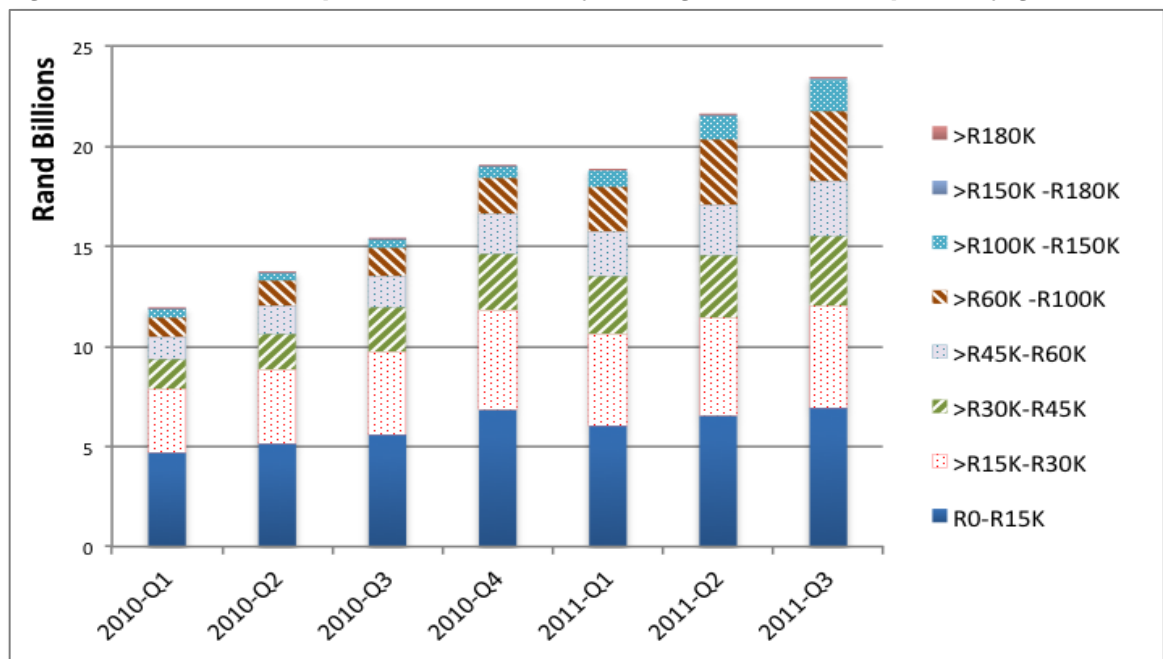
Figure 17 – Unsecured personal loans book analysis: Agreement size Q3 2011



Source: NCR request for statistical information from ten participating credit providers

There has been strong growth in the >R60k-R100k segment of credit granted. This is illustrated in the graph below, which makes up some 14.9% in Q3 2011, compared to some 9.2% in Q3 2010. There has also been an appreciable increase in the >R100k-R150k segment, which makes up some 6.9% of credit granted in Q3 2011, compared to some 2.6% in Q3 2010.

Figure 18 – Unsecured personal loan analysis: Agreement size quarterly growth



Source: NCR request for statistical information from ten participating credit providers

Unsecured personal loans with balances of over R150k do not make up a significant portion of the gross debtors book, 0.5% or R58.6m, in respect of Q3 2011, as illustrated in the graph that is set out above.

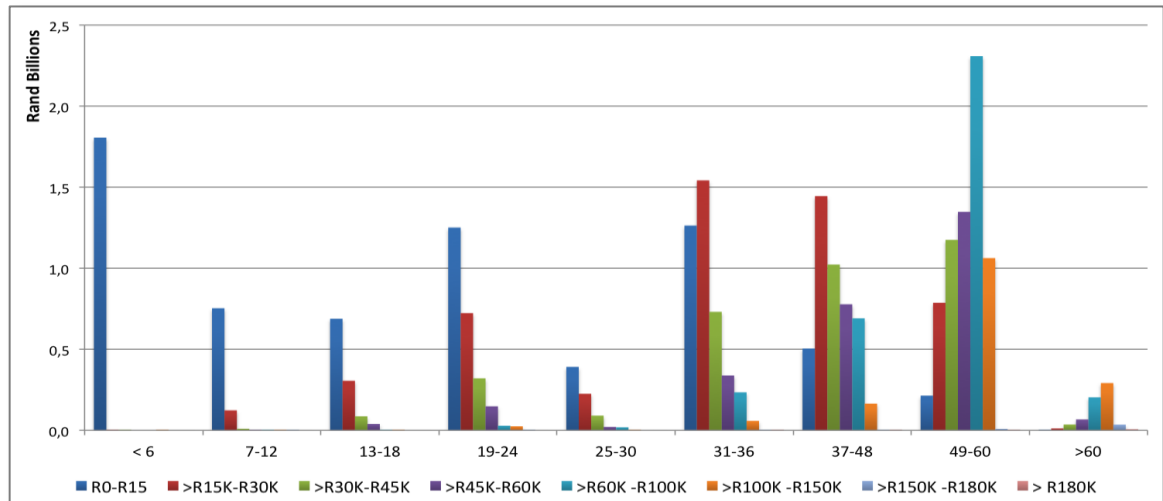
Providers that are well established in the unsecured personal loans market, notably African Bank and Capitec, argue that there is clearly a need for large unsecured personal loans (up to R150k and in some cases up to R230k), in view of the decline in the major banks appetite for secured lending products, notably in respect of mortgage advances.

6.4 Unsecured personal loan term

There has been some lengthening of the term over which unsecured personal loans are granted, most notably in respect of the 49 to 60 month category, which represents 29,5% of total credit granted (rand value) in Q3 2011, in comparison to 19,8% in Q3 2010.

Credit granted during Q3 2011 has been analysed according to loan sizes across loan term categories in the graph below.

Figure 19 – Unsecured personal loans granted according to loan size across term categories



Source: NCR request for statistical information from ten participating credit providers

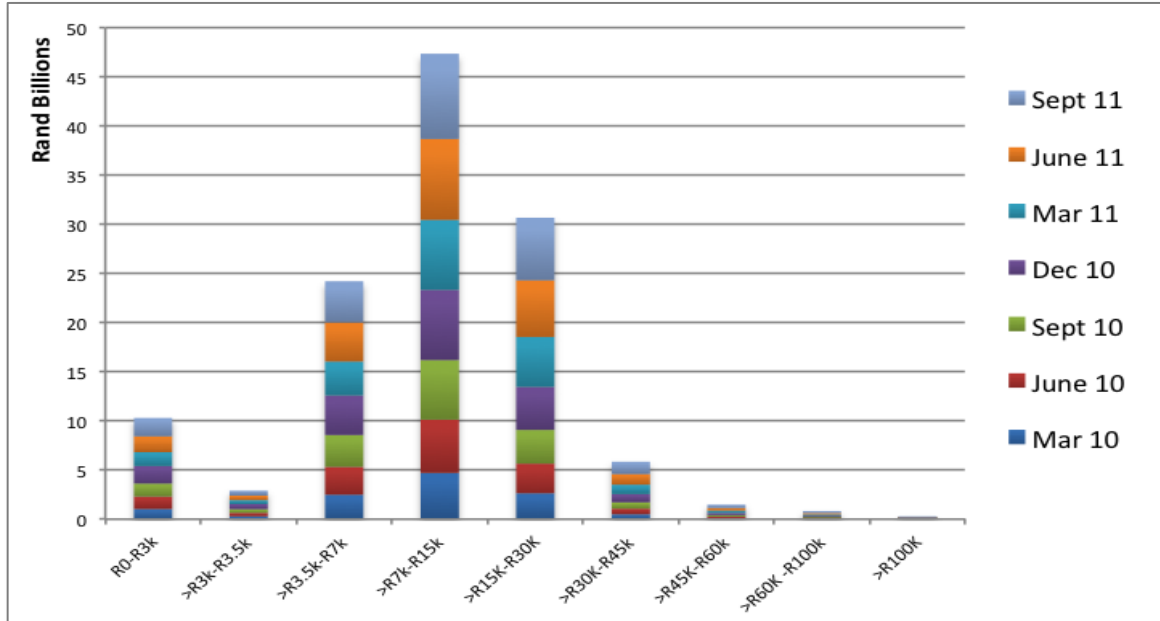
The majority of unsecured personal loans granted have terms that exceed 30 months, 69,8% in respect of Q3 2011. This is illustrated in the above graph, which indicates that the longer term agreements have a spread of loan sizes across all loan term categories.

Most loans granted in amounts of less than R15k have terms of 36 months or less. On the other hand, most loans with amounts exceeding R100k fall into the 49 to 60 month category, with some reflected in the longer than 60 month category.

6.5 Consumer income levels

The majority of unsecured personal loans (rand values) that are granted fall into the middle income consumer categories. This is shown in the stack graph below which reflects that, over the period Q1 2010 to Q3 2011, unsecured personal loans granted are concentrated in the >R3.5k-R30k categories, the most significant category being >R7k-R15k.

Figure 20 – Unsecured personal loans granted according to income level of consumers



Source: NCR request for statistical information from ten participating credit providers

In Q3 2011 credit granted as a percentage of total credit granted was as follows >R3.5k-R7k - 17.9%, >R7k-R15k - 37.0%, >R15K-R30 - 27.2%.

A relatively small proportion of unsecured personal loans has been granted to higher income consumers, with the Q3 2011 advances to the R30k and larger categories representing some 7.8% of the total, with the majority thereof in the >R30k-R45k category.

Some 8.0% of the unsecured credit granted in Q3 2011 has been recorded in respect of the lower than R3k income category.

6.6 Consolidation loans

Growth in “consolidation loans” has become a feature of the unsecured personal loan market. These can be described as loans that are taken up by consumers to repay a number of smaller loans (two or more) in order to consolidate their debt into a single loan.

The Feasibility study¹⁵ covering the credit market stated the following:

“The growth of the unsecured loan book – accounting for around 7.8% of new lending in the fourth quarter of 2007, to 17.8% in the third quarter of 2010 illustrates how important this category of credit has become.”

The indications are that the level of debt consolidation lending has remained high and could represent as much as a quarter of the new loans granted on an ongoing basis. The demand for consolidation loans is, in itself, a factor that requires consideration.

Consolidation loans will not represent new credit where there is not also an element of further credit extension, i.e. a new loan is obtained. It is evident that adjustments to disaggregate the impact of consolidation loans are needed to understand the full picture that is presented in the unsecured personal loans statistics, i.e. the 53.1% growth rate in unsecured personal loans over the last year would be reduced if consolidation loans are excluded from the credit granted statistics. However, the gross debtors book statistics would not be affected and no adjustment would be required in this regard. The NCR is aware of the aforementioned considerations has taken these into account in analysing the credit market.

Credit providers do not all target consolidation loans to the same extent. Some actively pursue consolidation loans as a business strategy, while others will provide loans to consolidate the debt of consumers where asked to do so, but do not actively advertise this form of credit or pursue it as a strategic growth opportunity.

Whether the increasing focus on debt consolidation is in the interests of consumers will depend on a number of factors, notably in respect of the following:

- Access to additional credit where the consolidation loan includes an element of new credit, which would be assessed in the light of the affordability thereof;
- The outstanding balances on the existing loans that are repaid in the light of the repayment term of the consolidation loan;
- Potential lower service fees where the number of loans that a consumer has is reduced, i.e. service fees will be paid on the consolidation loan as opposed to fees paid on each individual smaller loans;
- Potential to reduce the cost of credit where relatively large loans are taken out as opposed to a number of smaller loans which would each attract higher interest rates where they are not large enough to generate sufficient funds revenue for credit providers to cover costs at lower interest rates;
- New loan initiation fees in respect of the consolidation loan that is taken out to repay the existing smaller loans;
- Administration of a single loan instead of multiple loans; and
- Potential to mask the level of debt stress of consumers through the consolidation of loans.

For example, if a consumer has two loans with separate credit providers and requires further credit for which he makes application to a third credit provider who offers

¹⁵ Page 29

consolidation loan services. The following table serves as a base from which to discuss key aspects of consolidation loans.

Figure 21 – Consolidation loan illustration

Loan	Initiation Fee	Monthly Service Fee	Term	Commentary	Amount Advanced	New Credit When Loan is Granted	Monthly Installment - Interest 28%
Loan No. 1	R750 when the loan was initiated	R57 monthly	24 months	Existing loan repaid through consolidation. The Monthly service fee will no longer be payable.	R10,000	R10,000	R541.66
Loan No. 2	R750 when the loan was initiated	R57 monthly	24 months	Existing loan repaid through consolidation. The Monthly service fee will no longer be payable.	R10,000	R10,000	R541.66
Loan No. 3	R750 when the loan is initiated	R57 monthly	60 months	New loan consolidating loans 1 and 2 together with further advance of R10,000.	R30,000	R10,000	R1,134.43

The above illustrates that a consumer could consolidate a number of loans into a single loan. This will have the effect of reducing the monthly service fees paid on the smaller loan when the consolidation loan is entered into. However, the consumer will typically be required to pay an initiation fee on the new consolidation loan (for example up to R750 once off, as opposed to the current maximum which is R1,140) and the consumer will have to pay the monthly service fee for this loan (for example R57 per month, which is the current maximum) and the monthly service fees of the smaller repaid loans will fall away. If the 2 smaller loans are repaid half way through the life of the credit agreements in question, then R684 would be saved on one agreement over the remaining 12 months, which would be compared to the amount of the consolidation loan initiation fee. Any cost to the consumer would be viewed by consumers in terms of the benefits that would be derived, which, in the above example, will include access to additional credit.

Where consolidation loans are provided taking into account the affordability thereof in a manner that does not result in over indebtedness and the costs and implications are understood by the consumer, this can be seen as being a favorable outcome. However, if further advances, either during the debt consolidation process or subsequent thereto, results in the consumer becoming debt stressed or pushes the consumer into a perpetual indebtedness cycle, this would be an unfavourable outcome.

It is suggested that consideration should be given towards obtaining statistics from credit providers that will allow for an analysis of the extent of consolidation lending as well as the characteristics thereof. This will facilitate ongoing monitoring of the credit market developments in this regard.

7 LEVEL OF COMPETITION

7.1 Introduction

This section of the report highlights observations in respect of competition in credit market in relation to the growth in unsecured personal loans.

7.2 Consideration of study interview input

When participants in the study were asked “what is the level of competition in South Africa?”, one of the typical responses was to point out the significant growth in the lending books of a number of credit providers that have their roots firmly planted in the micro-finance market, notably African Bank and Capitec. Their growth has, to some extent, been at the expense of the large banks, which have, since the financial crash in 2008, adopted conservative lending policies.

It is clear that the African Bank and Capitec business growth achieved in recent years has shown the larger credit providers (banks) that lower cost delivery can be leveraged to access the credit market to a greater extent than achieved in the past. A number of these providers have recognised that their market share in the personal loans product has not kept pace with the organisations that have exhibited strong growth in this market over the last 2 years. They have taken steps to address this as can be seen from the growth in their unsecured lending balances that have been reported in Form BA900 which is submitted to Bank Supervision Department of the South African Reserve Bank, as well as the statistics that are submitted to the NCR.

This is, to some extent, an indication of the attractiveness of the unsecured personal loans market to credit providers in the current market conditions. The success of the business models that have been followed by the “predominantly unsecured lending” banks in achieving strong lending growth has been recognised by the large South African banks and they have targeted unsecured personal loans in order to grow their lending books and they actively compete for market share.

7.3 Comparative quotes

NCA disclosure and other requirements are designed to improve consumer understanding of the credit they take up as well as encourage competition in the credit market. One of the outcomes relating thereto should be consumer choice where comparative quotes will provide valuable information in making credit decisions, specifically in respect of the cost of credit.

It is evident consumers do not generally obtain quotes from multiple credit providers to the extent envisaged by the drafters of the NCA. The level of “shopping around” for credit and the price insensitivity in respect of a broad base of consumers is a concern from a competition perspective.

Benefits would be derived from investigating the underlying causes of consumer behaviour that is “installment” focused as opposed to “cost of credit” focused.

7.4 Pricing

The average interest rate of the ten participating credit providers in respect of unsecured personal loans is 23.5%. This indicates that unsecured personal loans are a relatively costly form of credit for consumers, i.e. in comparison to secured credit options, but unsecured personal loans are not all offered at the interest rate cap, which was 32.1% during the time the study was conducted.

However, the question of why some credit providers generally offer all clients rates at the margin requires some consideration. For instance, this could be due to their market positioning, where they are niched into a segment that services consumers that are not supplied with credit by the large banks.

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 written at the margin will provide perspectives needed to understand the effectiveness of consumer protection in the light of the market dynamics.

7.5 Credit life

The cost of credit life products that are generally sold as a condition of taking up an unsecured personal loan is not disclosed in a manner that provides consumers with an integrated view of the overall cost of credit.

Where consumers are not able to obtain easily understandable overall cost of credit information this will detract from their understanding of the implications of taking out credit, and will not encourage market competition to the extent that would be possible in circumstances where there is transparent disclosure.

It is noted that consumer protection considerations relating to credit life insurance are being addressed in various industry initiatives that involve a number of regulatory authorities and public sector stakeholders. There is clearly an overlap of supervisory responsibilities relating to credit life insurance in that the same staff members of credit providers sell both unsecured personal loans and credit life insurance relating thereto albeit that different laws regulate the respective consumer perspectives of credit provision in terms of the NCA and advice and intermediary services in respect of financial products in terms of FAIS. A coordinated industry approach to addressing the respective challenges will yield benefits from a consumer protection perspective, i.e. in recognising the interrelated interests of consumers.

There is value to consumers in “fairly priced” credit life insurance. Notably, benefits were derived therefrom after the financial crash where there were high levels of job losses. However, it is advisable that the value that is derived by consumers be considered using an industry wide perspective, i.e. as part of a broad consumer research initiative.

7.6 Smaller credit providers

The study has not focused on the smaller credit providers in terms of the stated scope thereof. It is submitted that benefits would be derived from further analysis of the supply of credit outside of the ten largest credit providers. The different organisation types have different characteristics could be positioned differently within the market.

8 COMPLIANCE

8.1 Introduction

This section of the document addresses compliance perspectives obtained from a high level review of credit agreements obtained from the ten credit providers that participated in the study, as well as input obtained from interviews, meetings and workshops held over the course of the research project.

8.2 Compliance with NCA requirements

Experience has shown that where financial services industry laws are brought into effect, it typically takes some time for regulated entities to come to terms with the requirements and to develop compliance structures and processes to comply therewith. The NCA has been in effect since 2006 and credit providers have had some seven years to develop their compliance responses thereto, however, the level of compliance will be dependent on numerous factors, including the clarity of the regulatory requirement, guidance provided to address regulatory uncertainty, the business impact or implications of requirements, cost and benefits of compliance, as well as the supervision and enforcement of compliance.

Where regulatory requirements are not actively enforced in an environment where the consequences of non compliance (fines, penalties, sanctions, reputational and operations considerations) are not adequate to incentivise compliance, the level of compliance will tend to be relatively low as well as inconsistent across regulated entities / persons.

8.3 Policies and procedures

The indications are, at face value, during interviews held with credit providers that participated in the study, the ten largest providers of unsecured personal loans have policies and procedures that address credit risk as well as compliance with regulatory requirements. The governance framework and process of credit providers is central to the implementation and effectiveness thereof.

A number of industry stakeholders have questioned whether all credit providers have developed a so called “compliance culture”. The study that has been carried out has not been designed to answer this question in any depth - A review of the adequacy and effectiveness of credit provider control frameworks within their governance structures, which will have a significant impact on compliance culture, has not been included in the scope of the study.

Organisational culture is driven by numerous interrelated factors, which, in a compliance context, are dynamic and multifaceted in nature.

It is submitted that benefit will be derived from consideration of the governance of credit providers towards compliance with NCA requirements.

8.4 Level of compliance

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. These relate to the likes of the provision of quotes and pre-agreement statements, affordability assessment, and various aspects of market conduct.

It is suggested that consideration should be given to the underlying causes of compliance shortfalls that have been identified.

This study has not been designed to assess the level of compliance by credit providers. Further research would be needed to in this regard.

8.5 Review of credit agreements

A review of credit agreements submitted by credit providers that participated in the study highlighted considerations that are relevant from a regulatory compliance perspective.

Importantly, the conclusions reached from the research which underpins the commentary set out below should not be seen as being representative of credit provider compliance in the industry as a whole. The sample of 300 consumers that has been selected by credit providers is not representative of the population of consumers with unsecured personal loans and is not independently determined in a manner that will relate to the wider credit market. The perspectives set out below are intended to furnish the NCR with information that may be relevant from a supervisory perspective. Where assurance is required relating to the level of compliance by credit providers, an appropriate review of a representative sample would be required.

It is evident that, since the implementation of the NCA, disclosures contained in unsecured personal loan credit agreements have significantly improved. However, the layout, format, clarity and complexity of the language used in respect of the different credit provider agreements varies significantly.

Based on an analysis of the sample agreements submitted by the ten participating credit providers, excluding the agreements where the repayment frequency was not monthly, the following observations have been made.

Nature of the loan agreements:

- The loan amounts advanced in terms of the credit agreements ranged from R998.00 to R118 000.00. The average loan amount was R 25 113.52;
- The number of instalments in terms of which these loans were repayable ranged from 3 to 84 months. The average number of instalments was 35 months;
- No deposits were payable by any borrower in order to obtain these loans;
- In 96% of the loans reviewed, the instalment frequency was monthly. The other agreements were repayable weekly and fortnightly;
- The option to pay the initiation fee upfront was not disclosed or clearly disclosed by all the lenders. The approach varies significantly from one lender to another;

- The disclosure of default charges, the circumstances under which they will be imposed and the manner in which they will be charged is not always clearly disclosed by the lenders;
- The amount of collection costs that will be levied is not disclosed;
- Nine of the ten lenders disclosed the implications of default;
- Eight of the ten lenders disclosed the consumer's right to apply to a debt counsellor to be declared over-indebted.

Credit Life:

- With the exception of two lenders, maintaining credit life was a condition of loans. It is noted that one lender provides credit life at no cost to the borrower covering the outstanding loan balance in the event of death or retrenchment of the borrower. The cost of this is covered by interest and fees on the loan and the borrower will have a clearer understanding of the cost of the loan in these circumstances;
- Where credit life is a condition of the loan, in all instances, with the exception of one product of one lender, the borrower is given the opportunity to substitute a policy of his or her own choice;
- Four of the lenders did not disclose the commission earned in respect of credit life in all their products;
- Five of the lenders provide credit life in terms of a cell-captive arrangement.

Fees & charges:

- The interest rates levied by the lenders ranged from 0% to 32.1% per annum in respect of unsecured personal loans and between 40% to 60% in respect of the 14 loans falling within small loan category. Notably, when including credit life in the calculation, this maximum reached a high of 82.4%;
- Two of the lenders levied the maximum rate of 32.1% per annum in respect of all their loans and one lender levied the maximum rate of 32.1% per annum in respect of the majority of their loans;
- The majority of lenders charged the maximum monthly service fee of R57.00 per month in all instances or the majority of their loans;
- The initiation fees charged varied from R0.00 to the maximum of R1 140.00. The average initiation fee charged was R611.08;
- No lenders charged any further fees or any charges in respect of optional insurance;
- The average rate of interest excluding credit life was 27.79% per annum and the average rate of interest when including credit life was 38.4% per annum, on average 10.6% per annum higher.

Disclosure:

- In respect of the majority lenders, the following information was clearly disclosed in the pre-agreement statement and quotation:
 - The loan amount;
 - The instalment amount (including interest, fees and credit life);
 - The number of instalments;
 - The total of all instalments (including interest, fees and credit life);
 - The initiation fee;
 - The monthly service fee;

- The monthly credit life payable;
- Whether any additional charges were levied;
- Any further optional insurance;
- The annual interest rate;
- The method of repayment;
- The date of first payment; and
- The date of last payment.
- Certain lenders failed to disclose certain information, including:
 - The last date of payment (generally applicable in revolving credit facilities);
 - The date of first payment (in certain large credit providers, where reference was made to date on which the monies would be advanced);
 - The method of payment; and
 - The monthly credit life (as this is calculated on the outstanding loan amount on a monthly basis).

Affordability Assessments:

- Three of the lenders did not include their affordability assessments for review;
- Two of the lenders did simple affordability assessments, one of which considers only living expenses and monthly loan repayments and leaves no provision for other emergencies;
- The remaining lenders did more detailed affordability assessments. Interestingly one of the lenders has a “default expenditure”, which is levied where the borrower’s expenditure is deemed not high enough.

Other observations:

- In general, the purpose of a loan agreement is not recorded therein – This would provide relevant information relating to the usage of credit;
- The employer of the borrower is also not known in all instances, but it is evident that some lenders appear to be targeting government employees.

The question of whether the improved disclosure in credit agreements has resulted in benefits to consumers through the encouragement of healthy consumer credit behaviour should be considered. The inclusion of summary information in table format in the pre-agreement statement and quote has perhaps had the most significant impact in this regard. This has facilitated the provision of relevant information “at a glance”.

It is suggested that there will be benefits from further research into consumer behaviour relating to credit take-up.

8.6 Reckless lending

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.

This lack of specification in respect of affordability assessments has both favourable and unfavourable implications for consumers and credit providers. On the one hand, the high-level requirements contained section 80 of the NCA allows individual credit providers to interpret them in a manner that is suitable for their particular business and consumer profile. This provides flexibility and will not result in a “one size fits all” approach that can be counterproductive. On the other hand, the limited specification of what will be acceptable from an affordability perspective or guidance relating thereto will mean that credit provider compliance responses will vary from credit provider to credit provider and there will be a risk of an “unlevel playing field” leading to undesirable practices in a competitive business environment.

It is submitted that the level of indebtedness should be viewed from 2 broad perspectives. Firstly, from 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 each category of consumer at a national level.

8.7 Impact of affordability assessments on the level of indebtedness

The level of indebtedness in South Africa is impacted by affordability assessments that are conducted by credit providers. Credit providers that participated in the study have represented that they have processes and controls that are designed to comply with their obligation to conduct affordability assessments. However, it is generally felt that further specification relating to how affordability should be assessed is required.

A study into the overall level of consumer indebtedness would provide the macro view needed to develop an industry monitoring approach that enhances the industry understanding of the link between individual affordability assessments undertaken by credit providers and the overall level of indebtedness of consumers at a macro level.

8.8 Affordability guidelines

It is reasoned that a best practice approach to affordability assessments should be developed by the NCR in order to provide credit providers with guidance that will encourage the development and implementation of policies and procedures that will promote the achievement of regulatory objectives in a framework that allows for flexibility which is suitable to the range of credit providers in the credit industry.

Rules based guidelines are not, at this juncture, recommended. It is reasoned that, in view of the complex, multidimensional considerations that are addressed when assessing affordability, there is a high probability of unintended consequences where narrowly defined affordability criteria are specified in terms of the NCA or regulations thereto, i.e. in the absence of an extensive investigation into the implications of the rules in question. Furthermore, when industry or individual circumstances change it is important that any affordability assessment requirements be flexible enough to remain relevant and effective in their consumer protection objectives.

9 COST OF CREDIT

9.1 Introduction

Relevant regulatory requirements in respect of the cost of credit and market practices relating thereto are addressed in this section. It is noted that the aforementioned should be read in the light of a specific study that have been undertaken by the NCR relating to the cost of credit in the South African market, which has not been published at the time that this report was prepared.

9.2 Regulatory requirements

Cost of credit requirements are specified in terms of the NCA. These can be categorised as follows:

- Interest, subject to prescribed maximum rates;
- Initiation fee, subject to prescribed limits stipulated in the NCA;
- Service fee, subject to prescribed limits stipulated in the NCA; and
- Credit life insurance.

Consideration of the costs referred to above will provide insights into the implications for consumers in respect of the high growth in respect of unsecured personal loans.

Other items that may be charged by a credit provider are:

- Default administration charges; and
- Collection costs.

9.3 Cost of credit

Unsecured loans are not a full substitute for secured lending in that, due to its terms and conditions thereof, 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, unsecured personal loans is 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 product characteristics.

Interest represents the largest source of revenue for credit providers, which price for risk in setting interest rates that are charged. Unsecured personal loans will typically be written at rates that exceed the prime interest rate and are offered up to the interest rate cap, which is 32.1% at the time the research was conducted. The Q3 2011 statistics obtained from the ten largest providers of unsecured personal loans shows that the average interest rate was 23.5%.

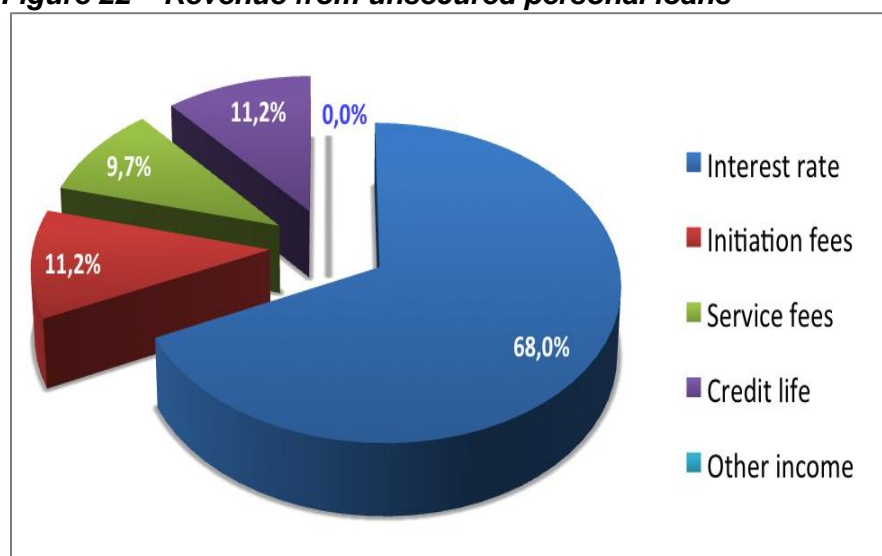
On the other hand, secured lending is typically provided at significantly lower interest rates than those offered by credit providers in respect of unsecured lending. Although the cap in respect of mortgage agreements is set at 17.1%, rates that are offered are typically at or close to the prime interest rate.

The cost of credit has been positively impacted by the current low repo rate. However, the likelihood of this low rate pattern continuing into the future should be considered. Changes in economic conditions could place upward pressure on rates, which could translate into a rising interest rate pattern. This will mean that existing variable rate lending will be repriced upwards and new loans will be written at higher rates.

The other unsecured personal loan revenue streams play a significant role in the cost of credit to consumers, i.e. initiation fees, service fees and credit life insurance.

The graph that is set out below illustrates the percentage of revenue received by credit providers in respect of each of the primary revenue streams from unsecured personal loans. This is based on Q3 2011 statistic obtained from credit providers.

Figure 22 – Revenue from unsecured personal loans



Source: NCR request for statistical information from ten participating credit providers

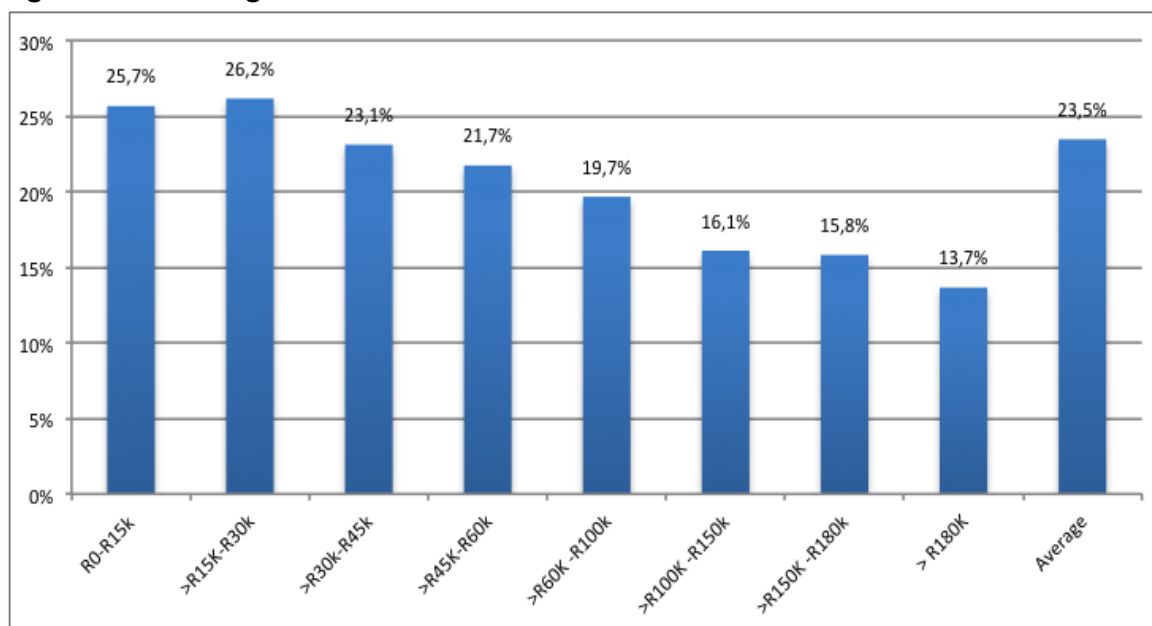
The above graphical analysis represents gross revenue per revenue category (the costs relating to each revenue stream are not taken into account in order to show a net contribution to credit provider income statements). It is noted that the credit life revenue represents the credit providers' share of premiums that are payable by consumers. The 11,2% credit life component of total revenue would be larger if the full cost to the consumer was included, i.e. making this revenue stream the second largest in respect of unsecured personal loans.

9.4 Pricing across loan sizes

The graph set out below illustrates the average annual percentage interest rate for loan size categories.

This reflects that there is differentiated pricing across different loan sizes, ranging between an average rate of 26.2% for the highest cost category and some 13.7% for the lowest cost category, the overall average being 23.5%.

Figure 23 – Pricing across loan sizes



Source: NCR request for statistical information from ten participating credit providers

This was calculated using income and average gross debtors book statistics for the quarter ended September 2011. Each of the revenue streams was divided by the average balances in question in order to calculate an average percentage rate.

9.5 Pricing for risk

Credit providers price for risk in respect of loans that are advanced to consumers. For instance higher risk customers would be charged higher interest rates and lower risk customers would be charged lower interest rates.

This is logical in that where clients represent a relatively low credit risk to a credit provider, lower interest rates would need to be applied in order to achieve a targeted return because the likelihood of a write off or provision for loss as a result of default is lower, i.e. and visa versa for relatively high credit risk exposures.

It is evident that certain lenders price their unsecured lending book across a spectrum of rates, starting with prime rates that are given to their best customers and increasing to relatively high rates for higher risk customers, subject to a maximum which is determined with reference to the applicable interest rate cap.

However, other credit providers offer all unsecured credit at the margin, i.e. at or near interest rate cap, currently 32.1%. Provided that these organisations offer credit to higher risk clients only, this is intuitively logical.

If it can be shown that they have a range of clients with different risk levels, this could mean that lower risk clients in their portfolios are obtaining credit at a relatively high cost. However, these organisations can represent that they are taking on the customers that have not found success in obtaining credit in the larger credit providers and they all fall

into a higher risk category. The extent to which this is the case has not been researched as part of the current study.

9.6 Fixed and variable rates

The majority of the unsecured personal loans book is written at fixed rates. This means that when the South African interest pattern changes over time, the interest rate that is applicable to unsecured personal loans clients will not change. This is beneficial to the consumer in a rising interest rate market, i.e. their repayments will not increase when the repo rate increases, or the South Africa interest rates on which the unsecured personal loans are linked to change.

Clearly, once the loan matures or is paid up and the consumer requires further funding this will be negotiated at the rate applicable at the time of taking up the new agreement, which may be at a higher rate if there is a rising interest rate pattern.

9.7 Repayment multiple

A “loan repayment multiple” can be defined as the number times the total installments in respect of a loan exceeds the capital amount advanced. This can be determined taking into account all amounts that are payable by the consumer, i.e. capital amount, fees, charges, interest and credit life.

It is submitted that the disclosure of the repayment multiple for a loan will assist consumers in understanding the impact of taking out credit as opposed to using cash. 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 determine the implications thereof.

The scenario set out below illustrates how the repayment multiple is impacted by different interest rates. The key variables are:

Loan term	- 60 months
Loan amount	- R25,000
Initiation fee (capitalised)	- R1,140
Credit life monthly	- R140 (0.56% of loan amount)
Service fee monthly	- R57

In the calculation of the repayment multiples in the tables below, all variables other than the interest rate are kept constant. The repayment multiple has been calculated separately for each cost of credit component.

Figure 24 – Calculation of average rate and repayment multiple: 32.1%

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	26 644,60	8 400,00	1 140,00	3 420,00	39 604,60
Average balance	16 601,00	16 601,00	16 601,00	16 601,00	16 601,00	16 601,00
Average rate	0,0%	32,1%	10,1%	1,4%	4,1%	47,7%
Installments	25 000,00	26 644,60	8 400,00	1 140,00	3 420,00	64 604,60
Repayment multiple	1,00	1,07	0,34	0,05	0,14	2,58

The above shows that, in respect of the scenario assumptions, the repayment multiple is 2.58. In other words a consumer will repay 2.58 times the initial loan of R25,000 which amounts to R64,604.60 over the 60 months in question. The significant contribution of credit life insurance to the repayment multiple is set illustrated, i.e. “0.34 times”.

Where the interest rate for an unsecured personal loan is reduced to 15%, the impact on the repayment multiple is set out below.

Figure 25 – Calculation of average rate and repayment multiple: 15%

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	11 172,13	8 400,00	1 140,00	3 420,00	24 132,13
Average balance	14 896,17	14 896,17	14 896,17	14 896,17	14 896,17	14 896,17
Average rate	0,0%	15,0%	11,3%	1,5%	4,6%	32,4%
Installments	25 000,00	11 172,13	8 400,00	1 140,00	3 420,00	49 132,13
Repayment multiple	1,00	0,45	0,34	0,05	0,14	1,97

The above table shows that, in respect of the 15% interest rate loan, the contribution of interest to the repayment multiple is reduced to “0.45 times” (from “1.07 times” where the interest rate is 32.1%), i.e. reducing the overall repayment multiple to “1.97 times” (from “2.58 times” where the interest rate is 32.1%).

The average rate and repayment multiple methodology is a useful tool in analysing the overall cost of credit of a loan. This is used in a number of sections of this report in order to illustrate cost of credit considerations.

From a disclosure point of view, it is suggested that consideration should be given to the provision of information to consumers that include the following:

- Overall cost of credit expressed as a percentage;
- Repayment multiple;
- Installment repayment including all costs; and
- The total amount repayable over the loan term.

There are practical challenges relating to the disclosure of an overall cost of credit expressed as a percentage in that certain cost elements are not “dependent” on the loan balance and the calculation of average balances is technical in nature. On the other hand the repayment multiple methodology is comparable between loans, but the time value of money is an important consideration in this regard.

9.8 Review of interest rate caps and pricing

Credit providers as well as the industry experts that have been interviewed as part of the study have indicated that a review of the regulated interest rate caps, fees and charges should be carried out on a regular basis. It has been represented that access to finance is adversely impacted where these do not keep pace with inflation or market conditions.

It has also been represented that there is a need to review the formula that is used in terms of the NCA in setting interest rate caps. Specifically, various stakeholders have indicated that the base rate is too low and the multiplier used in the formula has a pro cyclical effect, making debt most expensive when customers can least afford it. It is understood that the credit industry has made proposals to the NCR in this regard.

This is the subject of a separate NCR project and has not been addressed in this report.

9.9 Cost of credit considerations

It is submitted that consumer dynamics in the credit market and disclosure of the cost of credit requires attention.

Where consumer behaviour is primarily driven by the amount of the installment that is paid in respect of loans, as opposed to behaviour is supportive of understanding for the cost and implications of credit, this is not optimal. Integrated efforts across regulators, supervisors and industry stakeholders would be needed to address the challenges that are evident in respect of the implications of taking up credit for individual consumers, as well as the respective segments of the consumer credit market in general.

It is noted that further research is needed to establish the factors contributing to the “tipping point” into over-indebtedness of consumers as well as other matters that require attention.

Disclosure of the full cost of credit to consumers, particularly in respect of credit life, should be considered. This will provide the full picture in respect of costs and will be enhanced through the disclosure of a loan repayment multiple.

Unsecured personal loans lending at the margin, i.e. where loans are priced at or close to the interest rate cap, represents a relatively high risk from a supervisory perspective. Monitoring of the performance of loans according to pricing levels would yield information that will be of value in understanding the credit market from an indebtedness perspective.

10 MARKET PRACTICES

10.1 Introduction

Previous studies have put forward recommendations relating market practices of credit providers. Further, the focus group sessions that have been held, as well as input provided by various industry stakeholders during the current study, have highlighted matters that require consideration from the NCR. These are addressed in the commentary below.

10.2 Zero percent loans

The practice of offering zero percent loans to consumers is currently being applied. This typically involves relatively small loans (less than R5,000) over short terms (less than 12 months), where the initiation fee and monthly services fees are adequate to cover the costs of the loan. In terms of input received from credit providers, this appears to be primarily used for marketing purposes, i.e. to attract clients that may want to take out further loans once the “zero percent” loan has been repaid.

The scenario set out below illustrates how a zero percent loan can be structured in the light of the aforementioned. The key variables are:

Interest rate	- 0%
Loan term	- 9 months
Loan amount	- R5,000
Initiation fee (capitalised)	- R650
Credit life monthly	- R28 (0.56% of loan amount)
Service fee monthly	- R57

Figure 26 – Zero percent loan illustration

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	-	252,00	650,00	513,00	1 415,00
Average balance	3 138,89	3 138,89	3 138,89	3 138,89	3 138,89	3 138,89
Average rate	0,0%	0,0%	10,7%	27,6%	21,8%	60,1%
Installments	5 000,00	-	252,00	650,00	513,00	6 415,00
Repayment multiple	1,00	-	0,05	0,13	0,10	1,28

The scenario shows that the overall cost of credit (calculated by comparing all costs as an annual percentage of the average balance of the loan) is 60.1% and the repayment multiple would be 1.28.

It is noted that 2 of the 300 unsecured personal loan agreements that were requested from the participating credit providers were “zero percent loans”. This indicates that this type of loan is currently being provided to consumers.

The practice described above may in future be used by an increasing number of credit providers if it is found to be successful in attracting new business. It is recommended that consideration should be given to reviewing whether this could lead to circumstances where consumers will not understand the implications of credit that is taken up.

10.3 Payment holidays

A number of credit providers offer payment holidays to consumers, either at the time of entering into a credit agreement where repayments are delayed for a number of months, or over a specific period where certain consumers find it difficult to make payments. The loans will accumulate interest over the payment holiday period, which will be capitalised or paid if the consumer makes up the installments that are missed.

Certain payment holidays that are granted by credit providers will be in the interests of consumers, for example where a consumer in good standing would like to miss an installment in December where it is expected that expenditure in this month will be high or the consumer will earn reduced income due to seasonal factors, this will allow the consumer time to either pay additional amounts to catch up the installments missed, or extend the term of the loan repayments at the consumers option.

However, there will be circumstances where payment holidays could be detrimental to consumers, for instance where the implications of the payment holiday in question are not understood by the consumer. For example, where a consumer is offered a payment holiday at the outset of a loan, say for the first two months, and it is not understood that interest will accrue over the period of the payment holiday, this could be misleading for the consumer.

This debate set out above should, however, be seen in the light of the apparent price insensitivity of a significant segment of the unsecured personal loans market. Based on input provided by industry experts during interviews, credit providers during meetings and consumers during focus group sessions, as well as industry stakeholders during workshops, it is evident that some consumers do not generally “shop around” for credit and do not compare costs between credit providers. This general approach by consumers may contribute towards consumers not fully understanding cost of credit alternatives.

10.4 Advertising

It is evident that a wide spectrum of credit providers are targeting unsecured personal loans as part of a lending growth strategy. This is supported by a number of high profile advertising initiatives by credit providers.

Industry stakeholders have expressed concern relating to the level of advertising, as well as the manner that the advertising is being delivered, which may be through various media. Reference was made to direct marketing which is undertaken using sms messages. This typically advises a consumer that a certain amount of credit will be available if application is made in this regard.

Stakeholders have referred to a “take it or leave it” approach in sales interactions that are applied by some credit providers. This appears to be a matter that requires some attention in respect of some smaller credit providers, i.e. where credit provider staff provide limited information relating to the credit that is offered and simply indicate that the consumer should “take it or leave it” in a high pressure sales driven approach.

The so called “compliance culture” of staff that offer loans to consumers has been raised by various industry stakeholders in respect of advertising practices. It is reasoned that a number of aggressive advertising practices that do not appear to comply with NCA requirements are a reflection of certain credit provider attitudes towards consumer protection.

10.5 Multiple loans

Input provided by various industry stakeholders has indicated that multiple loans are provided by credit providers. Further, this is evident from statistics and data extracts provided by credit providers as part of the study.

A consumer could, for example, take a loan from a credit provider and then at a subsequent time take further unsecured personal loans from the same credit provider or from other credit providers to meet further credit needs. Where this is affordable to the consumer, this practice is not necessarily cause for concern, however, the subsequent loans may make the consumer increasingly more indebted to the point that over-indebtedness occurs.

There are practical challenges in determining where over-indebtedness takes place in a multi-loan scenario. This is illustrated in the following example in which a consumer has a declared monthly surplus of income over expenses of R2,000 and takes out 6 unsecured personal loans over a period of time.

Consumer affordability assessment information before taking out loans:

Consumer monthly income - R12,000
Consumer monthly costs - R10,000
Consumer surplus income - R2,000

It is assumed that the surplus of income before finance costs (R2,000) is maintained over the full scenario period.

Unsecured personal loans – 6 loans each with the following profile:

Interest rate - 28%
Loan term - 36 months
Loan amount - R10,000
Initiation fee (capitalised) - R750
Credit life monthly - R40 (0.4% of loan amount)

In the above example, at the time of taking out the first loan, the consumer's surplus income of R2,000 will cover the monthly installment thereof. However, as further loans are taken up the level of indebtedness is increased and the surplus income is decreased.

If the loans are taken out at 6 month intervals, the following table illustrates the consumer's debt status over 36 months from the time the first loan is taken out.

Figure 27 – Multiple loan illustration

Month	Number of Current Loans	Total Loan Amounts Outstanding R	Total Monthly Installments R	Surplus Income R
1	1	10,556	542	1,458
6	2	20,073	1,083	917
12	3	27,952	1,625	375
18	4	34,171	2,167	-167
24	5	38,485	3,250	-1,250
36	5	29,668	3,250	-1,250

The above illustration shows that the third loan places the consumer in a small surplus income position (R375, which represents some 3.1% of gross income). The fourth loan places the consumer in a deficit position (R167, which represents some 1.4% of gross income) and the fifth loan increases the deficit (R1,250, which represents some 10.4% of gross income). In the absence of default, the first loan will be repaid in month 36.

If it is assumed that the consumer then suffers a life event (for example illness, destruction of an asset without insurance cover, or loss of income) this could cause financial stress. The question of which loan has pushed the consumer into over-indebtedness is relevant. Further, which of the above loans have been advanced recklessly by the respective credit providers?

It is submitted that the legal and debt review implications for credit providers in respect of loans that resulted in the consumer becoming over-indebted should be different to the implications for credit providers that can be shown to have advanced loans that did not do this. The applicable regulatory requirements are not currently specific in respect of affordability assessments and over-indebtedness and there are a number of legal and compliance uncertainties in this regard.

It is noted that the above example is for illustration purposes only. There are numerous situations and variables that could be modeled to provide a comprehensive picture. It is suggested that this should be undertaken in order to inform the process of developing industry guidance in respect of affordability assessments.

10.6 ATM and electronic delivery loans

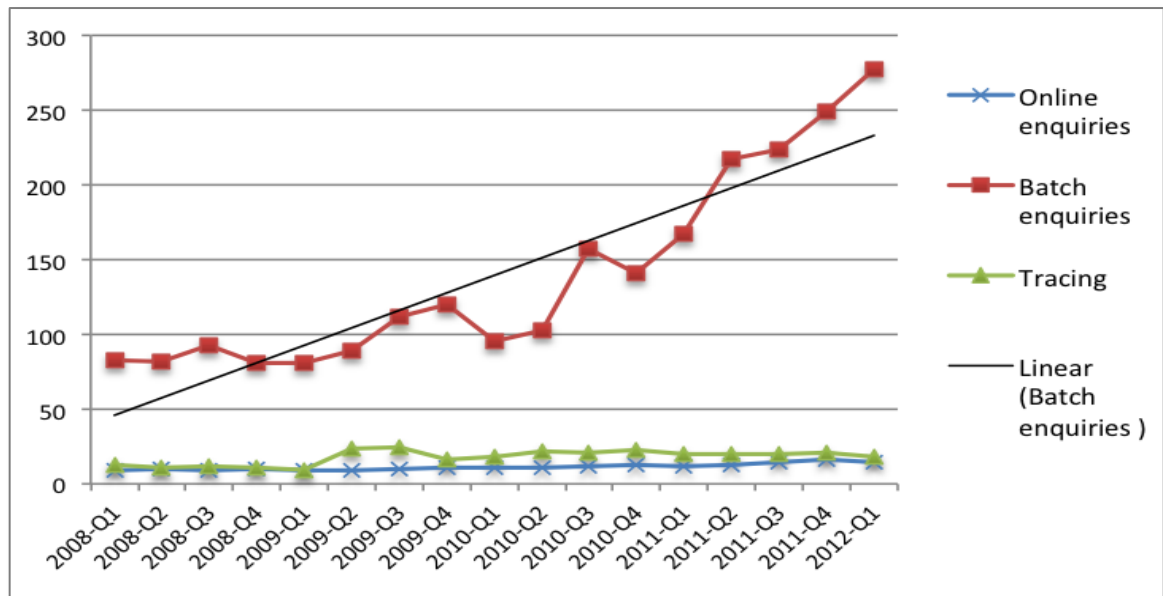
A consumer may apply for and be granted a loan via ATM and other electronic delivery channels, for instance internet or cellphone banking. The loans in question are granted on the strength of certain criteria that are determined by the credit provider.

These delivery channels have, to an extent, increased access to finance, however, it is suggested that the implications thereof, from an affordability assessment process perspective, should be considered. Credit provider reporting of the aforementioned loans (to credit bureaus) that are taken out and repaid within the same month or reporting period should also be considered.

10.7 Credit bureau enquires

The level of credit bureau enquires has significantly increased over the last year. This is driven by a number of factors, for instance credit provider enquires in respect of consumer credit applications, credit provider enquiries relating to marketing or research purposes, or consumer enquires in respect of their own credit status.

Figure 28 – Credit bureau enquiries (millions)



Source: NCR data obtained from credit bureaus

As can be seen in the graph above, batch enquires have increased strongly over 2009 levels. This could, to a large extent, be as a result of credit providers making bureau enquires for marketing / research purposes, i.e. in that the growth in enquires appears to have outstripped normal growth in business volumes that can be expected in relation to loan applications.

10.8 Consumer considerations

The study that has been carried out has focused on the market practices of the credit providers that have the largest unsecured personal loans books. The scope of the project has, of necessity, been limited in the light of the timeline and other constraints that are faced.

A range of practices that are designed to aggressively target the unsecured personal loans market have been identified. Analysis and monitoring of these practices, combined with comprehensive consumer education initiatives that promote healthy consumer demand behaviour, will play a positive role from a consumer protection perspective.

11 CREDIT LIFE INSURANCE

11.1 Introduction

Key aspects of the credit life insurance that is sold by credit providers in respect of unsecured personal loans are highlighted in the commentary that follows.

11.2 Market practices

Credit life insurance which is offered in relation to unsecured lending is a feature of the South African credit market. This typically covers obligations in terms credit extended in the event of the consumer's death, disability or retrenchment.

In terms of credit agreements that are entered into, consumers may generally substitute the credit life insurance offered with an agreement of their own. However, the indications are that consumers do not, in the main, "shop around" for credit life insurance and will tend to take the insurance that is offered by credit providers when they apply for an unsecured personal loan.

The cost of credit life insurance constitutes a significant component of the overall cost of an unsecured personal loan. This is illustrated in part 9 of this report.

The Feasibility¹⁶ study states the following:

"If we are correct in seeing credit life insurance as highly liquid security on the loan extended, then perhaps it is more accurate to see the provision of credit life insurance as converting an unsecured loan into one that has highly liquid security under certain

¹⁶ Feasibility. Privileged report to the National Credit Regulator. The cost of credit, access to credit and associated market practices. August 2011. Page 46.

conditions. We suggest that applicability of the interest rate cap for unsecured credit loans where credit life insurance is a condition of the loan warrants further investigation by the NCR”.

This raises the issue of whether unsecured loans can be viewed as being truly unsecured if credit life insurance is taken up by consumers?

Further, it is suggested that the question of whether credit life insurance is fully understood by consumers from a product offering or cost of credit perspective should be considered.

11.3 Cost of credit life products

Credit life products that are offered by credit providers represent a significant revenue stream for credit providers. This can be considered to be part of the cost of credit to consumers, particularly in view of the general market practice to make credit life insurance a condition of unsecured loans.

It is evident that the revenue from credit life insurance cover to consumers is set at different levels by different credit providers. A sample of credit agreements provided by credit providers reveals that credit life premium income ranges from 2.8% to 32% (annual percentage rate) of the loan amount granted, the average being some 7.6%. A more comprehensive sample, which includes credit agreements from the smaller credit providers, may show a somewhat different picture, however, the aforementioned provides a valid insight into the levels and variability of the credit life revenue of the ten largest providers of unsecured personal loans.

The benefits and costs relating to unsecured personal loans and credit life insurance should be separately evaluated, however, to the extent that revenue from one product serves to cross subsidise revenues from any other product this could lead to unhealthy credit supply or demand behaviour. It is suggested that consideration should be given to any potential cross subsidisation between the products in question.

11.4 Security provided by credit life insurance

Credit life insurance provides an element of security to credit providers. This serves to mitigate risk where the insured events occur which means that the capital that is advanced is recovered in this regard.

It is evident that it is general practice to either require consumers to take out credit life insurance as a condition of the credit granted or in some cases to provide the option to take out credit life insurance. This may be offered by a credit provider through a cell captive arrangement or by a party that is independent of the credit provider. Either way, provided that the underwriting risk is adequately managed, this will mean that a credit provider's credit risk will be limited when a consumer dies, is disabled or is retrenched.

Bearing in mind that unsecured credit to consumers is generally offered to people that are formally employed, the insurance in question provides a valuable risk mitigant to credit providers where a consumer is retrenched or is disabled. Further, in the event of the consumer's death, the outstanding debt will be covered and the credit provider's recovery thereof is more likely.

The insurance cover is of value to consumers in that their debt commitments will be covered by a claim in respect of their credit obligations where the insured events occur. However, the level of satisfaction of consumers with the nature and extent of the insurance, as well the extent of the value to consumers, has not been addressed as part of the current study.

11.5 Credit life insurance - consumer considerations

Credit life insurance plays a significant role in supporting access to finance. It is suggested that any evaluation of the costs and benefits of credit life insurance should be seen in the light thereof.

Further research relating to credit life insurance from the perspective of the implications thereof for consumers would be required to evaluate the unsecured personal loans market. Key aspects include regulatory disclosure requirements, credit life cover, level of insurance of consumers and the security offered by the insurance cover in question.

Perhaps most importantly, it is suggested that enhanced disclosure of credit life insurance costs 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. This could include both the rand amount of the credit life insurance payment and the basis of the cost (rate used in relation to amount covered).

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.

12 RISK MITIGATION

12.1 Introduction

This section highlights considerations relating to the mitigation of risks by credit providers, specifically in respect of consumer protection perspectives.

12.2 Credit provider risk mitigation

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.

Unsecured personal loans comprise some 9.2% of the total consumer credit book (Q1 2012) and are increasing faster than any other product. However, 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. Representatives of both the Bank Supervision Department of the South African Reserve and the Banking Association of South Africa as well as credit providers themselves have indicated that the recent strong growth in unsecured personal loans provided by banks does not, at this juncture, represent a threat to the safety and soundness of the financial system. It is understood that this is based on an assessment of banking industry statistics in the light of current credit market conditions.

It is logical that, at some point, where very high growth rates are maintained over time, the level of credit granted through unsecured personal loans will be unhealthy. Past experience has shown that, under certain conditions, both credit providers and consumers are prepared to grant and take up more credit than is sustainable and it is reasoned that the impact on consumers of overextended markets will remain a concern.

While the build up of credit risk in non-bank credit providers would not threaten the safety and soundness of the financial system in the same way as it would in banks, it would be of value to consider the range of credit providers that have been identified in section 4.11 of this document.

In the final analysis, credit that is granted to consumers should be viewed from both the perspective of the impact thereof on the safety and soundness of the financial system as well as from the perspective of the impact on the level of indebtedness of the consumers in question.

Even though the financial system may not, at this juncture, be threatened in respect of unsecured personal loan growth, there may be unfavourable implications for large numbers of individual consumers.

12.3 Risk management structures and processes

All credit providers that participated in and provided input towards the study indicated that the risk management frameworks and processes that have been adopted are central to their lending operations.

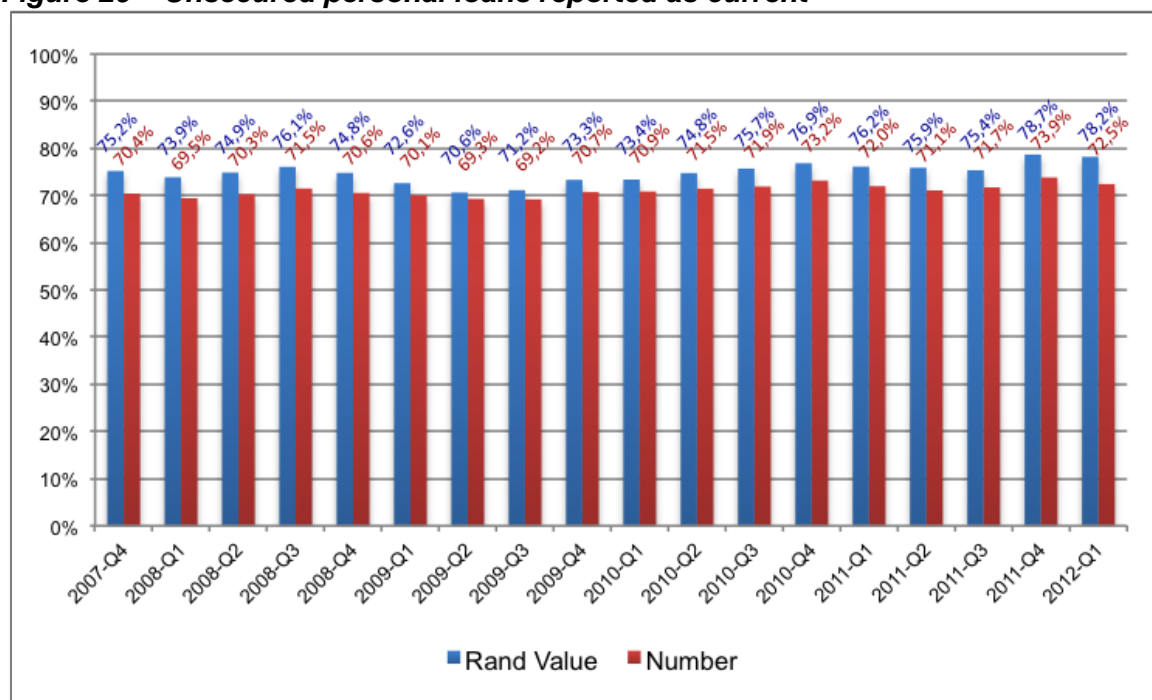
The information furnished by the credit providers in questionnaires submitted and interviews held reveals that, at face value, the larger credit providers have sophisticated risk management solutions which are designed to address risks relating to lending.

12.4 Unsecured personal loans book performance

Where unsecured personal loans granted result in a high level of overdues at an industry level, this would be a concern from a consumer credit health perspective.

The table that is set out below highlights the trend in unsecured personal loans overdues. This is sourced from the NCR statistics obtained from credit providers on a quarterly cycle in the Form 39 submissions.

Figure 29 – Unsecured personal loans reported as current



Source: NCR

The number and value of unsecured personal loans reported as “current” over the last two quarters show an improved picture in relation to that shown in the previous three years, the Q4 2011 statistics being: value 73.9% and number of accounts 78.7%. This improvement follows a decline in the trend over the quarters Q1 and Q2 2011, after a steady improvement seen from Q2 2009. There has, however, been some decline in the Q1 2012 level of loans reported as current, by 1.4% to 72.5%, as well as a decline in the number of accounts reported as current, by 0.5% to 78.2%.

The level of unsecured personal loans that have been classified as current is relatively low in relation to secured lending products, however, this is, to an extent, expected in the light of the inherently higher risk profile of the unsecured personal loans.

13 LEVEL OF INDEBTEDNESS

13.1 Introduction

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. Key aspects thereof are highlighted below.

13.2 Consumer indebtedness – Macro level

As described in part 4.6 of this document, the macro 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 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 more than three months in arrears, as described in part 4.8 of this report.

13.3 Consumer indebtedness – Micro level

From an individual consumer perspective, indebtedness is a function of a number of interrelated variables, as indicated in various sections of this report.

It is evident that the following requires attention from an unsecured loans perspective:

- Principle level guidelines would improve credit provider understanding of the regulatory requirements in respect of affordability;
- Compliance by credit providers would be 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 implication of credit.

It is suggested that benefit will be gained from regulatory / supervisory consideration of indebtedness under the three legs highlighted above.

It will be in the interests of the credit industry to ensure that any guidelines that are introduced encourage healthily behaviour by both credit providers and consumers. This should, for example, discourage consumers from taking up levels of credit that they cannot service and promote lending practices that do not compromise credit providers that lend using sound credit criteria as opposed to those that encourage over-indebtedness.

14 ACCESS TO FINANCE

14.1 Introduction

This section addresses factors that impact on access to finance in respect unsecured personal loans, i.e. bearing in mind that this is one of the underlying objectives of the NCA.

14.2 NCA requirements

The implementation of the NCA has placed the emphasis on affordability as opposed to the level of income of consumers. This has changed the way in which consumers are assessed for credit purposes. For example, in the past, a credit provider may have used a general requirement that a loan will not be provided if the repayments will be greater than a certain percentage of gross income (for example 30% in respect of a mortgage application). This approach would no longer be acceptable, if it did not also incorporate and assessment of affordability, which should consider the consumers income and expenses.

14.3 Access to finance

The variables that drive credit demand within the regulatory framework are dynamic and complex.

Consumers in the lower income levels use unsecured loans as a tool for accessing finance for a variety of reasons. These consumers generally do not have assets that can be secured to provide credit and will not have income levels that will allow for the acquisition of assets using secured credit avenues such as mortgages and hire purchase agreements.

Mortgages provide the platform for the majority of the credit that is provided to consumers in the higher income levels, although the proportion of credit provided is falling as the growth in unsecured credit takes up an increasing share of the overall credit market. This trend has been driven by a number of factors that are identified and considered in this report. Other forms of secured lending are also relatively inaccessible to lower income consumers. To the extent that consumers do not have access to secured lending, when they qualify for and it is appropriate to grant such credit, this will not be in the interests of consumers.

On the other hand, unsecured lending can be used to obtain credit to finance the acquisition assets and expenditure of consumers. This is to an extent a stepping stone towards economic development across a broad base in South Africa.

In some instances credit is needed for day to day survival purposes. This is evident in the FinScope study that has been carried out.

14.4 Pricing

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. Notably, if any one revenue stream to credit providers is reduced, this will mean that less credit risk can be taken on by the credit provider in that margins will be reduced and less credit will be extended to consumers, i.e. where pricing has in the past been validly set to cater for risk.

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 may be met through alternative sources, which could include loans from family members or the likes of “loan sharks”.

14.5 Access to credit across provinces

Access to credit across provinces in South Africa is analysed in the table set out below for the period 2008 to 2011.

Figure 30 – Unsecured lending across provinces

Province	2008	2009	2010	2011
Total ¹⁷	5 317 050	5 913 817	4 585 261	8 236 033
Western Cape	12%	12%	11%	11%
Eastern Cape	15%	10%	14%	12%
Northern Cape	2%	1%	3%	2%
Free State	4%	2%	6%	5%
KwaZulu-Natal	15%	19%	23%	19%
North West	7%	13%	4%	4%
Gauteng	28%	32%	30%	32%
Mpumalanga	5%	6%	3%	5%
Limpopo/Northern Province	11%	5%	6%	11%

Source: FinScope

The above shows that the proportion of unsecured lending across the provinces has remained relatively stable over the analysis period, with increases in the KwaZulu-Natal and Gauteng statistics.

Access to finance is a function of the level of income of consumers. Importantly, all of the participating credit providers market 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. It is, therefore, expected that the level of lending will be higher in Gauteng and other major business centers.

14.6 Consumer behaviour

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.

¹⁷ FinMark Trust. FinScope Study. 2008 to 2011 datasets.

The above is not exhaustive and is simply meant to illustrate the drivers that may draw consumers towards over-indebtedness. A comprehensive study into consumer credit behaviour will provide perspectives that will inform access to finance considerations.

It is evident that the implementation of the reckless lending related provisions in the NCA is not, on its own, sufficient to prevent a significant number of consumers from becoming over-indebted. There are a range of variables that should be considered relating to access to finance in relation to affordability and the promotion of consumer credit health. These include various practical NCA implementation matters, including compliance, enforcement and various interpretation challenges where there is not adequate specification or guidance to promote a level playing field.

14.7 Consumer vulnerability

It is recognised that a significant proportion of the unsecured personal loans are granted to consumers that are vulnerable to changes in economic conditions. The stability of the sources of income of consumers in various segments of the consumer credit market is an important consideration.

It is submitted that where loans are extended to a broad base of consumers that have income sources that may be subject to unfavourable changes, this may, in itself, mean that the repayment of loans may be inherently compromised for a large number of consumers to the point that high levels of overdues could be expected on an ongoing basis.

Access to credit that is facilitated through unsecured credit products should be seen in the light of the need to encourage consumers to live within their affordability limits.

15 FEATURES OF UNSECURED PERSONAL LOANS

15.1 Introduction

Benefits and concerns relating to unsecured personal loans are highlighted in this section, i.e. in the light of the role that is played by this product in meeting the mass and middle market consumer demand for credit and the promotion of access to finance in South Africa.

15.2 Ease of obtaining credit

The characteristics of unsecured personal loans mean that 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.

This allows access to this form of credit with fewer administration challenges on the part of both credit providers and consumers. The speed at which the credit can be granted can be viewed as a benefit to consumers.

15.3 Unsecured personal loans

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 to meet 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 credit providers being willing to extend secured credit to only the best credit risk consumer categories, i.e. for reasons that could include low margins relating to secured credit in a regulatory environment that does not incentivise the extension of credit in this regard. Where market conditions do not make certain types of lending attractive to credit providers, as described in part 5.3 of this document, they will tend to find alternative business opportunities. If this is the driver behind the high growth in unsecured personal loans, as has been represented by various stakeholders that provided input, this is an unfavourable outcome for consumers.

It is logical that the above argument has merit and 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 limited access to secured lending by consumers.

15.4 Sustainability

Credit providers view the growth in unsecured personal loans as sustainable, particularly in the light of the South African industry's performance during the recent financial crash. All participants in the study indicate that current unsecured personal loans books are currently profitable and an "extreme" event would be needed to threaten the sustainability thereof.

However, some industry commentators point to the level of indebtedness in South Africa. The question of what is driving indebtedness levels requires some consideration. Where the credit records of credit active South Africans are impaired at levels approaching 50%, this is cause for concern.

The following was stated during an interview held:

"My concern in this particular topic that you are researching in the boom in unsecured lending is: How can we have 50% of the market credit impaired and have a boom in unsecured lending?"

When the NCA was drafted, it was reasoned that "obsolete information and information that shouldn't be taken into consideration in pricing" should be excluded from credit bureau records.

Further, the question of whether credit providers are incentivised to avoid the impairment of the record of consumers has been raised. For instance, if a consumer has an impaired credit record with a particular credit provider, the credit provider is in a strong position in that the consumer will not be able to go elsewhere for credit and will "become

a loyal customer”. Whether this argument has merit or not has not been researched as part of the current study.

It is argued by some commentators that the interest rates that are charged by credit providers in respect of unsecured personal loans are too high and contribute to the level of indebtedness of consumers, particularly where the term of an agreement is relatively long.

A further challenge that has been identified is that NCA requirements relating to affordability are not specific. An interview participant stated the following in this regard: “So consequently credit providers can make any excuse as to what affordability assessment they have done.” This, to an extent, illustrates the need to differentiate between the legal recourse of consumers from compliance enforcement. The NCA has provided consumers with options relating to addressing their over-indebtedness, however, where reckless lending takes place, the indications are that this is difficult to prove, especially in an environment where NCA affordability requirements are not framed in a clear and specific manner.

Although benefit will be derived from the implementation of high level guidance relating to affordability, a “one size fits all” rules base specification is not recommended. This is, at this juncture, likely to be overly restrictive.

It is submitted that it is preferable to gear up from a supervisory perspective to review the compliance of credit providers and to make use of enforcement options to addresses instances of non-compliance. Increased resources would be required by the NCR to supervise compliance in this regard.

15.5 Consumption led economy

The indications are that unsecured personal loans are, to an extent, used to finance consumption expenditure. While such expenditure can result in positive implications from a macroeconomic perspective, where this is made across the broad base of consumers at unsustainable levels and serves to weaken the credit health of consumers, this could be seen as the making of a consumer credit sustainability concern.

NCR stakeholders have indicated that this could lead to a so-called “hollow economy”, which involves seeing the consumption in question as having limited enduring benefits for consumers and results in an increase in the indebtedness of consumers (beyond levels that would be considered healthy) and reduces future capacity of consumers or acquire assets. This terminology is new and it is suggested that there would be merit in further consideration thereof by the NCR.

15.6 Consumer understanding of the cost of credit

It is evident from input furnished by credit providers, as well as information obtained from consumers during focus groups, that the a large segment of consumers in the lower and middle income categories are driven by the amount of the installment of a loan as opposed to the individual components of the cost of credit, i.e. through a comparison of interest rates, initiation fees, service fees or credit life insurance offered by different credit providers.

The indications are that when such consumers are given a quote in respect of an application for an unsecured personal loan, their primary driver is, in general, whether the loan installment can be repaid. This is not, in itself, a matter of concern, however, where this is done to the exclusion of consideration of the interest rate and other costs, it does not support the achievement of one of the core objectives of the NCA, i.e. relating to the promotion of competition in the credit market.

15.7 Consumer satisfaction

The study has provided perspectives that should be taken into account in assessing consumer satisfaction relating to the total cost of credit and other matters relating to unsecured personal loans. However, the scope of the study has not extended to an evaluation of the level of satisfaction of consumers in this regard.

The factors referred to in the commentary above require further consideration. This could be best addressed through research that is specifically designed to understand consumer behaviour in more detail.

16 EFFECT ON CONSUMERS FROM ALTERNATIVE METHODS OF FUNDING

16.1 Introduction

This section of the report highlights considerations that should be taken into account in evaluating the impact of credit extension on household income and cash flow.

16.2 Loan repayment variables

Three core variables should be considered in evaluating the impact of unsecured personal loans on consumers from a cost of credit perspective are:

- Capital amount advanced;
- Costs, i.e. interest rate, initiation fees, services fees and credit life insurance; and
- Term of the loan.

For instance, the bigger the capital amount advanced, the larger the interest paid will be in respect of a given interest rate, resulting in larger installments. The higher the interest rate charged, the larger the repayment installments will be. Extending the term of a loan will have the effect of reducing the amount of the periodic installments payable (typically monthly), but interest will be paid over a longer term, thereby increasing the cost of finance over the term of the loan.

For example, if an unsecured loan, say R10k, is priced at the margin, i.e. 32.1% (the cap which was in place during the course of the study) and the cost of finance is compared over 12 vs 36 month periods, the total amount repaid will, in nominal terms, be higher over the 36 month term. This is illustrated in the following scenario, the results of which are disclosed in the respective tables:

Interest rate	- 32.1%
Loan amount	- R10,000.
Initiation fee (capitalised)	- R650

Credit life monthly - R63 (0.63% of loan amount)
 Service fee monthly - R57

Figure 31 – Loan cost calculation over 12 months

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	1 941,24	756,00	650,00	684,00	4 031,24
Average balance	6 047,47	6 047,47	6 047,47	6 047,47	6 047,47	6 047,47
Average rate	0,0%	32,1%	12,5%	10,7%	11,3%	66,7%
Installments	10 000,00	1 941,24	756,00	650,00	684,00	14 031,24
Repayment multiple	1,00	0,19	0,08	0,07	0,07	1,40

Figure 32 – Loan cost calculation over 36 months

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	6 070,05	2 268,00	650,00	2 052,00	11 040,05
Average balance	6 303,27	6 303,27	6 303,27	6 303,27	6 303,27	6 303,27
Average rate	0,0%	32,1%	12,0%	3,4%	10,9%	58,4%
Installments	10 000,00	6 070,05	2 268,00	650,00	2 052,00	21 040,05
Repayment multiple	1,00	0,61	0,23	0,07	0,21	2,10

The above scenario shows that although the effective cost of credit expressed as a rate in terms of the average balance of the loan is lower in respect of a 36 month loan (58.4%) in comparison to a 12 month loan (66.7%), which is a function of the amount of time over which the initiation fee is amortised, the loan repayment multiple will be higher in respect of the 36 month loan (2.1 times) in comparison to the 12 month loan (1.4 times).

In other words the total installments for the 36 month loan will amount to 2.1 times the initial capital amount of the loan (excluding capitalised costs), which is 0.6 times higher than the 12 month loan repayment multiple.

It is suggested consideration could be given to viewing cost of credit in terms of the total cost perspective that is demonstrated in the table above. The practicalities and value of disclosing a total cost of credit figure, either as an annual percentage or as a repayment multiple, will depend on clear specification of the terms applicable to the loan.

16.3 Choice of credit type

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.

The extent to which secured credit and unsecured credit are substitutes for each other should be considered. In view of the characteristics of unsecured personal loans, this product is clearly not a full substitute for secured lending, particularly mortgage advances. Firstly, unsecured personal loans terms do not, in the main, extend past 60 months and are typically smaller than R150k, although there is some indication that credit providers are prepared to advance amounts of up to R230k (the level of business written with loans of this value is not currently significant). This means that these loans

would not, in the current lending profile of credit providers, allow for the financing of formal housing. However, a consumer could finance housing renovations and extensions as well as informal housing development. Based on input provided from credit providers relating to credit usage, the indications are that this is a feature of consumer unsecured personal loans usage. For instance, some 23% of the personal loans granted during Q3 2011 are reported to be used for building and renovation purposes. A loan of R150k could be used to finance all or more likely part of low-end formal housing. Further, consumers could jointly finance housing development or acquisition, i.e. where a number of consumers each qualify separately for an unsecured personal loan and pool their resources.

It is reasoned that consumers could also use unsecured personal loans to finance new vehicles which cost less than R150,000 or second hand vehicles below this value, particularly in respect of older vehicles (where security relating thereto is not acceptable for secured vehicle financing options). However, it is interesting that credit providers that participated in the study indicated that only 3% of the personal loans granted during Q3 2011 were used vehicle financing purposes. This is, to an extent, an indication that consumers have greater access to secured lending for vehicle financing purposes and need to rely less on unsecured personal loans than in respect of housing. However, credit usage statistics that are obtained over a longer period of time will provide further perspectives in this regard.

16.4 Unsecured personal loans vs mortgage finance

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.

The use of unsecured personal loans to finance housing instead of mortgage finance is illustrated in the scenario below. This shows the implications of funding a R150k extension to a house using the 2 alternatives.

Unsecured personal loan:

Interest rate	- 23.5%
Loan amount	- R150,000
Loan term	- 60 months
Initiation fee (capitalised)	- R1,140
Credit life monthly	- R600 (R0.4% of loan amount)
Service fee monthly	- R57

Figure 33 – Unsecured personal loan scenario

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	107 114,26	36 000,00	1 140,00	3 420,00	147 674,26
Average balance	91 161,07	91 161,07	91 161,07	91 161,07	91 161,07	91 161,07
Average rate	0,0%	23,5%	7,9%	0,3%	0,8%	32,4%
Installments	150 000,00	107 114,26	36 000,00	1 140,00	3 420,00	297 674,26
Repayment multiple	1,00	0,71	0,24	0,01	0,02	1,98

Mortgage loan:

Interest rate	- 9%
Loan amount	- R150,000
Loan term	- 240 months
Initiation fee (capitalised)	- R3,000
Credit life monthly	- R600 (R0.4% of loan amount)
Service fee monthly	- R57

Figure 34 – Mortgage scenario

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	177 379,37	144 000,00	3 000,00	13 680,00	338 059,37
Average balance	98 544,09	98 544,09	98 544,09	98 544,09	98 544,09	98 544,09
Average rate	0,0%	9,0%	7,3%	0,2%	0,7%	17,2%
Installments	150 000,00	177 379,37	144 000,00	3 000,00	13 680,00	488 059,37
Repayment multiple	1,00	1,18	0,96	0,02	0,09	3,25

The scenario assumes an average unsecured personal loan interest cost as shown in section 9.4 above, 23.5% (which compares to a typical rate of some 16% for loans of in the region of R150k from a bank), as opposed to a 9% rate that could be obtained in respect of an access bond.

Clearly, the total mortgage installments (R488.1k, with a repayment multiple of 3.25) would be higher than the total unsecured personal loan installments (R297.7k, with a repayment multiple of 1.98 times) as a result of the lower monthly mortgage installment being repaid over a longer period of time (mortgage installment of R2,034 per month for 240 months and unsecured personal loans installment of R4,961 per month for 60 months).

However, the borrower pays more in real terms for the unsecured personal loan than for an access bond, notwithstanding the longer term of the bond. If the client could afford the higher monthly repayments for the unsecured personal loan and saves the difference between the unsecured personal loan payment and bond payment and invested the balance in a money market at 6% (average over last 5 years is some 8%) the borrower could pay off the loan after 5 years with a surplus.

An evaluation of the above scenario would depend on the behaviour of the consumer, i.e. if the monthly saving relating to the lower mortgage payment is not saved and is consumed there would be a lower surplus.

It is emphasised that the scenario has been included for illustration purposes only. It is not representative of the broad range of variables that could be changed to reflect different results. It simply compares the cost of an unsecured personal loan which is priced at 23.5% to the cost of a typical mortgage (extension to an existing loan).

16.5 Unsecured personal loans vs vehicle finance

The use of a secured vehicle finance product to finance a vehicle acquisition is illustrated in the scenario below. This shows the implications of funding a R150k vehicle at an interest rate of 13%.

Secured vehicle finance:

Interest rate	- 13%
Loan amount	- R150,000
Loan term	- 60 months
Initiation fee (capitalised)	- R1,140
Credit life monthly	- R600 (R0.4% of loan amount)
Service fee monthly	- R57

Figure 35 – Secured vehicle finance scenario

	Capital	Interest	Credit Life	Initiation Fee	Service Fee	Total
Total cost	-	55 193,97	36 000,00	1 140,00	3 420,00	95 753,97
Average balance	84 913,80	84 913,80	84 913,80	84 913,80	84 913,80	84 913,80
Average rate	0,0%	13,0%	8,5%	0,3%	0,8%	22,6%
Installments	150 000,00	55 193,97	36 000,00	1 140,00	3 420,00	245 753,97
Repayment multiple	1,00	0,37	0,24	0,01	0,02	1,64

The above illustration is simplistic - the only change in relation to the unsecured personal loan scenario above is the 13% interest rate - which has reduced the average cost of credit to 22.6% and the repayment multiple to 1.64. This translates into a lower monthly installment, which represents a cash flow advantage to the consumer in respect of the secured finance option (monthly payment of R4,096 for secured vehicle finance as opposed to the monthly payment of R4,961 for the unsecured personal loan in this example.

17 USE OF CREDIT

17.1 Introduction

Consumers make use of credit for various purposes. Consideration of consumer spending patterns together with an analysis of the statistics provided by credit providers affords a basis on which to identify matters that are relevant when considering the level of indebtedness at a macro level.

17.2 Unsecured personal loans

The characteristics of unsecured personal loans should be considered in relation to the usage thereof.

Firstly, unsecured personal loans amounts advanced are typically below R150,000, although some credit providers are making loans in excess of this amount. Further, the term of the loans is typically shorter than 60 months, with some loan periods of up to 84 months.

In view of the size and term of the loans, there are limitations to which the loans can be used to finance the assets or expenditure of consumers. For example, the loans 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 property extensions, paying a deposit on a house and education costs.

17.3 Credit usage statistics

Unsecured personal loans are used by consumers for a wide variety of purposes. These can be classified into 2 broad overarching categories, firstly “wealth creation” and secondly “consumption”.

It is reasoned that wealth creation related credit extension would include the likes of the following:

- Mortgage deposit;
- Building and renovations; and
- Education.

On the other hand, consumption related credit extension would include the following:

- Social family commitments; and
- Household consumption expenditure.

Further, some credit provided in respect of certain items could be for both consumption or wealth creation purposes. This will depend on the circumstances, for example in respect of:

- Vehicles; and
- Furniture.

Clearly, the above 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.

Based on input obtained from credit providers during interviews held, 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.

When credit providers were asked to indicate whether consumers used credit primarily for consumption purposes or for wealth creation purposes, all credit providers cautioned that the statistics that are available within their organisations are based on input provided by consumers for the purpose of obtaining credit and the information that is provided is not verified. It is reasoned that consumers that would like to obtain credit may lean towards indicating their reasons for the credit as wealth creation related as opposed to consumption related in that it may be perceived by them to be more likely to be favourably viewed by credit providers in the granting of such credit (even though this does not typically form part of the credit assessment criteria).

As part of the study, the ten participating credit providers were asked to furnish their assessment of what the predominant use of credit obtained through unsecured personal

loans in South Africa is, i.e. by choosing one of the following options included in the credit provider research questionnaire:

- Primarily for consumption purposes;
- Largely for consumption purposes with some wealth creation;
- Largely for wealth creation purposes with some consumption; or
- Primarily for wealth creation purposes.

A range of responses was received from credit providers in respect of their understanding of the use to which consumers put the credit obtained by them. In the main, credit providers indicated that they believed that usage was “largely for consumption purposes with some wealth creation” or “largely for wealth creation purposes with some consumption”, i.e. there was an even split of credit providers that held these views. Some credit providers thought that usage was “primarily for consumption purposes”, while one credit provider indicated that usage was “primarily for wealth creation purposes”.

What is clear is that credit is used for both consumption and wealth creation purposes. This is to some extent driven by the different markets that credit providers are targeting. For example, at the lower end of the market the credit may be seen to be used primarily for consumption purposes, while other market categories may reflect a relatively high component of wealth creation usage.

There are a number of factors that should be taken into account in assessing the usage of credit. Importantly, the accuracy of information provided by consumers to credit providers relating to credit usage when applying for credit should be considered.

Credit providers were also requested to furnish the NCR with information / statistics relating to credit granted during the quarter ended September 2011.

Specifically, they provided an analysis of the amounts that were disbursed to various third parties,

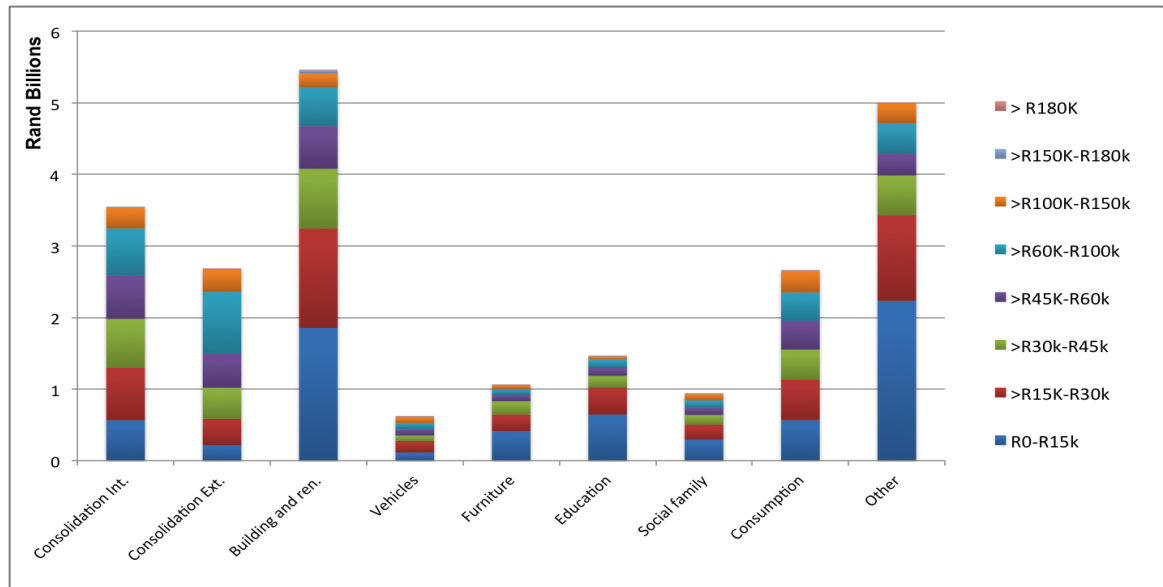
- Motor dealers;
- Building suppliers;
- Consolidation loans (internal); and
- Consolidation loans (external).

Where amounts were paid directly to the consumer’s account they were analysed into a number of categories:

- Mortgage deposit;
- Building and renovations;
- Vehicles;
- Furniture;
- Education;
- Social family commitments;
- Consumption; and
- Other.

Statistics provided by credit providers are analysed in the graph set out below. This reflects the rand value usage relating to the respective usage categories.

Figure 36 – Claimed unsecured personal loan usage



Source: NCR request for statistical information from ten participating credit providers

The above graph illustrates that, in terms of credit provider statistics in respect of Q3 2011, unsecured personal loans are used for both wealth creation and consumption purposes. The building and renovations category reflects a relatively large component of the total at R5.5bn, which is 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.

17.4 Consumer research

It is submitted that further consumer research would be required, including the execution of full consumer based credit survey, to determine consumer credit usage and the implications thereof.

18 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 agreement¹⁸.

“**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 operate¹⁹.

“**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.

¹⁸ Section 1 of National Credit Act No. 34, 2005.

¹⁹ South African Reserve Bank. <http://www.resbank.co.za>. Referenced 25 June 2012.