THE DEPARTMENT
OF TRADE AND INDUSTRY
SOUTH AFRICA

Credit Law Review

August 2003

Summary of findings

of the

Technical Committee

THE DEPARTMENT OF TRADE AND INDUSTRY SOUTH AFRICA

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Synopsis

i) Various developments over the past few years have indicated that consumer credit legislation needed an overview. These include the increase in micro-lending, concern about over-indebtedness, lack of progress in SME finance and, lately, abuses related to administration orders. The perception is that regulatory weaknesses are part of the problem, and that the current regulatory framework is fragmented, outdated and ineffectual in dealing with a complex market that increasingly affects consumers at all income levels.

ii) A number of reports have commented on the weaknesses in consumer credit legislation. These include (a) the Law Commission's 1994 review of the Usury Act; (b) the Strauss Report on Rural Finance; (c) the National Small Business Regulatory Review by Ntsika Enterprise Promotion Agency in 1999 and; (d) the Policy Board Report on SME Finance (Falkena Report, 2001).

iii) In March 2002, the Director-General of the Department of Trade & Industry (**the dti**), Dr Alistair Ruiters, asked the Micro Finance Regulatory Council (MFRC) to co-ordinate a review of the legislation on consumer credit, and to make proposals for a new regulatory framework. This included all consumer credit products covered by the Usury Act, Credit Agreements Act and Exemption Notice: thus, the full range of products from mortgages, credit cards and vehicle finance through to hire purchase finance and micro-loans. A committee was established to oversee the review. The committee consisted of Dr David Porteous, Mr Kgose Pule, Prof Roshana Kelbrick, Mr Moses Moeletsi and Mr Gabriel Davel. The report of the Committee assesses the weaknesses in the consumer credit market and the regulatory framework and recommends new legislation and changes in the enforcement framework.

iv) A number of other countries have undertaken similar reviews in recent years, and have subsequently modernized (or are in the process of modernizing) their consumer credit legislation. These include substantial credit law reviews by the UK, the European Commission and New Zealand. The Credit Law Committee was informed by these reforms in consumer credit policy abroad.

v) The Review included focus group discussions with consumers from a range of different income & racial profiles; workshops with consumer & industry representatives and a statistical and economic analysis of the consumer credit market.

vi) Consumers expressed a high level of dissatisfaction with the level of disclosure. They felt that the actual cost of credit was frequently much higher than disclosed, and that the mechanisms for complaints and redress were inadequate. Amongst the industry and consumer representatives there was a surprising level of agreement on the need for legislative reform. Areas of mutual concern were the inconsistent treatment of different types of credit (and credit providers), the need for better enforcement, and improved disclosure of the cost of credit.

vii) The research indicated serious weaknesses in allocation of credit, and very high cost of credit in a number of market segments. Most of the R361bn market consists of mortgages, overdrafts or personal loans and vehicle finance at moderate rates. However, the majority of consumers do not have access to these products. The majority of consumers only have access to products such as micro-loans, hire purchase and store cards - at much higher interest rates. Significant weaknesses in the legislative framework within which the consumer credit market operates, contributes to inefficiency and dysfunctionality. The Usury Act cap segments the market to the detriment of everyone except prime clients; there are weaknesses in debt collection and in access to court orders; collateral mechanisms are inefficient and difficult to enforce. Inaccurate and incomplete credit bureau information undermines credit providers' ability to assess risk and have a detrimental impact upon consumers. The fee structures in the banks' debit order system discriminate against low-income clients and small transactions while unequal access to the National Payments System undermines competition. In essence, the market is divided into a prime market, which is well serviced at moderate rates, and a "marginal market" which is rationed, inefficient and vulnerable to predatory practices, with effective interest rates much higher than the Usury Act cap.

Findings

I. The need for a review

Over the last few years, government has expressed rising concern about credit markets, and credit market legislation. Of primary concern was the following: -

- consumer representatives have become increasingly concerned about the effectiveness of consumer protection, particularly in relation to consumers in low income groups;
- access to finance remains a problem. This affects SMMEs and housing, and hinders progress in important parts of the national economic transformation and development strategy;
- there has been increasing concern with the level of indebtedness;
- there is mounting evidence of reckless behaviour by credit providers, and exploitation of consumers by micro-lenders, intermediaries, debt administrators and debt collectors;
- banks and other credit providers have indicated that inappropriate legislation curtails innovation and prevents them from serving the housing and SME market, as well as the low income personal finance market.
- the collapse of large micro lenders such as Unibank and Saambou highlighted underlying problems in the market and indicated that some of the regulatory problems may even introduce systemic risk.

This Report is the result of a detailed investigation by a Technical Committee that was established during 2002.

These proposals seek to support the overriding policy objectives of **the dti**, being the promotion of a stable, efficient and competitive credit market in which consumers' rights are adequately protected, and in which access to finance is improved, particularly for development purposes.

II. RESEARCH INTO THE CONSUMER CREDIT MARKET

Consumer attitudes

Focus group discussions demonstrated that South African credit consumers:

- Are ill informed about the terms of credit contracts and on their rights;
- In nearly all forms of finance, the consumers focus on obtaining the money, with little attention being given to either the cost of finance or the terms of the contract;
- Are often dissatisfied with the treatment received from and information provided to them by bank and non-bank credit providers.

Consumer comments indicate a high level of dissatisfaction with the information on the cost of credit and indicate frustration with mechanisms for protection and redress.

Industry and stakeholder views

Interviews and workshops were also conducted with credit providers, consumer bodies, representatives from the provincial consumer desks and other stakeholders.

There was a surprising consensus across these groups that:

- The current acts are obsolete, anomalous and should be replaced with a simplified, unified Credit Act;
- Enforcement capacity is weak, leading to widespread non-compliance and circumvention of legislation;
- Consumers have limited recourse;
- More and better focused consumer education is necessary;
- There is a need for a central credit regulator, instead of the current dispersed regulatory oversight.

Some of the more specific problems that were identified include:

- Usury Act ceilings are regularly circumvented by charging excessive credit life insurance premiums and other fees, and sometimes openly flouted;
- Serious weaknesses in insolvency law and certain sections of the Magistrates' Court Act (as relating to debt collection and enforcement against security) undermine housing and SME finance.

III. STATISTICAL PROFILE & ECONOMIC CHARACTERISTICS OF THE CONSUMER CREDIT MARKET

The consumer credit market in SA is worth some R361bn and comprises some 20 million accounts, including mortgages, vehicle finance, furniture finance and microloans amongst others. This excludes a further R366bn of credit extended to incorporated entities.

Approximately 75% of consumer credit consists of products that are predominantly used by the high-income groups (approximately 15% of the population), with the low and middle-income groups (85% of the population) using about 25% of consumer credit. The latter consists of products with an aggregate value of approximately R95bn. These include micro-loans, store cards, hire purchase finance and loans backed by provident fund guarantees.

The cost of credit varies dramatically between the different sub-markets and groups of users. High-income users have the choice of a broad range of products that appear generally to be competitively priced. Low- income consumers face limited choices in highly segmented markets. These range from loans against provident fund security - sometimes at rates close to prime - to furniture finance or payroll deducted micro-loans that could cost anywhere from 40% to more than 100% per annum; and unsecured micro-loans (payable by debit orders) where even mainstream banks are found to charge rates in excess of 100% per annum.

There are a number of economic factors to go some way in explaining the inefficiency and dysfunctionality in the allocation and cost of credit.

The consequences of these factors are: -

- High cost to consumers that does not result in high returns for suppliers;
- High returns do not attract new entrants, do not increase competition and do not lower prices;
- Banks and other large credit providers are finding it most difficult to enter the low-income market successfully;
- Suppliers are frequently unable to evaluate or accurately price for risk; and
- The market appears unable to evolve in a manner that would give low- income consumers access to low cost distribution channels or to the other benefits of economies of scale.

The weaknesses that lead to the outcomes as described above, include: -

- Inadequate rules on the disclosure of the cost of credit, with the result that the cost of credit is regularly inflated above the disclosed interest rate, through the inclusion of a variety of fees and charges (including excessive credit life insurance). This undermines the consumer’s ability to make informed choices, whether between cash and credit purchases or between different credit providers. It results in reduced consumer pressure on credit providers to reduce interest rates;

- An unrealistically low Usury Act cap causes low income and high-risk clients to be marginalised;

- Weak and incomplete credit bureaux information results in bad client selection, ineffectual credit risk management, in high bad debts *and thus in a huge increase in cost of credit*;

- Inappropriate debt collection and personal insolvency legislation creates an incentive for reckless credit provision and prevents effective rehabilitation of over-indebted consumers;

- Excessive predatory behaviour leads to high levels of debt for certain consumers and unmanageable risk to all credit providers;

- Inconsistencies in legislation related to mortgages and property transfers undermine consumers' ability to offer security and locks them into high cost, unsecured credit;

- Certain aspects of the Banks Act and National Payments System rules undermine competition in the consumer credit markets (while creating inequitable preferences for certain credit providers); while

- Regulatory uncertainty leads to credit behaviour that is orientated towards short-term profit taking, and a resistance amongst credit providers to providing longer-term finance (including housing and SME finance).

Although it is impossible to trace the cause of the high cost of finance (and limited access) to any single factor, the combination of factors that have been identified does appear to go a long way in explaining the problem.

IV. INTERNATIONAL PRECEDENTS

The governing legislation and regulatory arrangements in a number of other jurisdictions were considered in some depth during the course of the review. These include the European Union, Australia, New Zealand, UK and the USA.

The framework outlined in this Report is consistent with international best practice. However, in a few important areas a slightly different position has been taken in order to reflect the South African consumer profile, and to accommodate particular features of the South African consumer credit market. The measures against reckless lending and powers of intervention in respect of uncompetitive market conditions are examples of specific measures to counter specific South African problems.

V. PROPOSED POLICY FRAMEWORK

In formulating the policy proposals the committee sought to maintain a balance between the following policy objectives: -

- To create a legislative framework that is consistent with international best practice whilst accommodating South Africa's particular historic and developmental challenges;

- To remove obstacles to financial innovation and to create a regulatory environment that is conducive to increased finance delivery to SMMEs, low cost housing and low income consumers;

- To create a regulatory framework that is consistent in its treatment of different credit products and credit providers and that could be effectively enforced. And, above all, a framework that would allow for the elimination of *practices that undermine competition between credit providers*;

- Finally and most importantly, to provide effective consumer protection, effective access to redress and *full disclosure of the cost of credit so that consumers can make informed decisions*.

CREDIT MARKET REVIEW & POLICY FRAMEWORK

1 INTRODUCTION

South African Consumer Credit Legislation has not kept track with increasing sophistication and complexity in the modern consumer credit market. While the profile of credit active consumers has changed dramatically over the last decade, both in terms of race and income distribution, the legislation was drafted around the needs of a white middle class in the 1970s and 80s, at a time of limited access to credit by the black working class, and with asset based credit through the sellers of the goods having traditionally been the main form of credit for black consumers. There has been increasing income flows to the black population and changes in aspirations since 1994, yet the majority of black consumers are still denied credit facilities from the mainstream financial institutions (and banks in particular) and have access primarily to micro-loans and retail consumer finance. A gap has emerged between financial needs and the products available to meet such needs.

In a previous review, undertaken on the Usury Act, by the SA Law Commission, published in 1992, a number of exploitative practices were identified in the consumer credit market and it was recommended that the Usury and Credit Agreements' Acts be replaced by a new Consumer Credit Act. The National Small Business Regulatory Review by Ntsika Enterprise Promotion Agency in 1999 also identified the Usury Act as one of the obstacles to increased provision of finance to SMEs, which was confirmed in the report on SME access to finance by the Policy Board for Financial Regulation.

Over the last few years the problems in the consumer credit and small loans markets, and the need for regulatory reform, have become more and more obvious. These conclusions are based upon various references from the following reports: "The National Small Business Regulatory Review" by Ntsika Enterprise Promotion Agency: 1999, the Policy Board Report on SME Finance (Falkema Report, 2001): the report on "Cost, Volume and Allocation of Consumer Credit" by Dr P.Hawkins (produced during the course of this review): the report by the IRIS Centre of the University of Maryland, under the title, "Filling the Gap in South Africa's Small and Micro Credit Market: An Analysis of Major Policy, Legal and Regulatory Issues", as well as various sections from the detailed report of the Technical Committee.

- Various studies has indicated a lack of access to finance for SMEs;
- There are limited finance options for middle & low-income households, with low cost housing finance being one of the most pressing needs. Where finance is available, it frequently is from 'marginal lenders' and at high cost;
- The approach of "regulation by exemption" is not satisfactory;
- There is a need to counter the type of instability that was caused by the failure of Saambou and Unibank;
- Regulatory obstacles may be contributing to the inability of the formal banking sector to extend finance to low and middle income consumers and to SMMEs;
- There are concerns with credit bureaux practices that compromise consumers, and the lack of regulation of credit bureaux;
- There are concerns with abusive debt collection practices and the abuse of administrative orders by legal practitioners and others.

It appears that inappropriate legislation, whether the Usury Act, Credit Agreements Act or debt collection procedures in the Magistrates Court Act, and a lack of enforcement, have contributed to the current unacceptable state of affairs. These various factors and the increasing use of credit by low-income consumers have created an urgent need for a closer examination of our current credit legislation.

As a result, **the dti** appointed a Technical Committee to assess the position and to make proposals for a policy framework for the regulation of consumer credit. The objective is to ensure that consumers are not exploited and that an environment is created in which the credit providers can conduct their business profitably and responsibly.

2 Problems & Challenges in the Regulation of Consumer Credit

1. The statutes that regulate consumer credit in South Africa are: -

i) Credit Agreements Act

ii) Usury Act

iii) Usury Act Exemption Notice.

The existence of three different pieces of legislation[1] has created various problems in the market. There is no uniformity, and there is considerable scope for circumventing the legislation or for misinterpretation. Even though the obligation on the consumer is substantially the same in different types of finance obtained, the disclosure requirement and level of consumer protection offered by these different laws are unequal[2]. This exposes the consumer to risk whilst different credit providers are not treated equally.

2. These problems are aggravated by the fact that both the Usury Act and the Credit Agreements Act are outdated and are no longer appropriate to a modern and changing credit environment. The same is true for the sections of the Magistrates' Court Act that deal with debt collection, garnishee orders and related matters. This led to serious inconsistency in the enforcement of credit transactions, irregularities in debt collection and inconsistent interpretation by the courts. It thus substantially undermines consumer protection.

3. The Usury Act and Credit Agreements Act provide for a ceiling on the interest rate chargeable by credit providers. However, this is frequently circumvented when credit providers add costs such as credit life insurance, loan application fees, administration fees, club fees and various bank services charges. A survey of the various costs charged by credit providers indicate that the effective cost of credit can be increased by up to two or even three times above the limit imposed by the Usury Act cap – even for loans and credit that are governed by the Usury Act or Credit Agreements Act. In their current form, the Usury Act and Credit Agreements Act are thus ineffectual and potentially also dysfunctional.

4. Insufficient enforcement mechanisms have lead to frequently reported irregularities and abuse and have stigmatised certain segments of the credit markets, with the low-income markets being worst affected. This in turn discouraged reputable credit providers, in particular banks, from servicing this market segment and from providing more affordable finance to low-income earners.

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[1] Noting that the Exemption Notice is secondary legislation, being a regulation passed in terms of the Usury Act.

[2] E.g., the consumer's obligations are similar under a micro-loan, a personal loan from a bank or a hire purchase contract for the purchase of furniture. However, these three contracts are governed by different pieces of legislation and the level of protection and recourse is very different.

5. The inadequacy of the current legislative framework is demonstrated by the fact that an industry as big as the micro-lending industry, and which deals with some of the most vulnerable consumers, is dealt with under an "Exemption Notice".

6. South African consumers appear to be increasingly credit active. This is creating a danger of over-indebtedness, which may in turn undermine wealth creation or aggravate vulnerability and poverty. The dearth of mechanisms to restrict the South African consumer from borrowing in excess of his or her financial capability result in the consumer finding him or herself at the mercy of credit providers and unscrupulous managers of the administrative orders.

7. Disclosure of the cost of loans and credit is weak; marketing and credit advertisements are misleading and insufficiently regulated and door-to-door sales techniques are overly aggressive and intrusive. These mechanisms undermine the consumer's ability to take informed decisions between cash and credit purchases, between different credit providers and between credit purchases and savings or investment in durable assets such as houses. Increased regulation is needed to improve disclosure in all of these areas.

8. Credit bureaux play a critical role in credit provision. Many irregularities are reported, indicating a need for increased regulation of credit bureaux and credit information exchange.

3 Research: Consumer & Industry Views

During the course of the Credit Law Review, extensive research was conducted into different aspects of the consumer credit market. The areas that were covered are: -

- Consumer perceptions, assessed through focus group discussions;
- The views of industry representatives, consumer representatives and other stakeholders on the current regulatory framework;
- A quantification of the consumer credit market, in terms of value and cost of different products, and analysis of the factors that determine these outcomes.

The following research reports and papers were produced as part of the credit law review.

<u>Expert Opinion</u>

- Dymski, Gary A. "Interest Rates, and Usury in Emerging Markets". University of California. March, 2003;
- Hofmeyr, Herbstein & Gihwala Inc. " Report for the purposes of the Credit Law Review." December, 2002; and
- Meagher, Patrick. "Regulation of Payday Lenders in the United States". IRIS Center. University of Maryland. March, 2002.

Research Reports

- Hawkins, Dr Penelope. “The Cost, Volume and Allocation of Consumer Credit in South Africa.” FEASibilitY (Pty) Ltd March 2003;
- Reality Research Africa. “Credit Contract Disclosure and Associated Factors.” December 2002; and
- Rudo Research & Training. “A Market Research Report: Credit Law Review.” 18 December 2002.

3.1 Consumer views on credit providers and products

There are very high levels of dissatisfaction amongst consumers on the level of disclosure of the cost and terms of credit products, and similarly high levels of dissatisfaction with the credit providers’ treatment of complaints. Across all income groups and all credit products, consumers indicate that consumers “felt cheated” when the first loan or credit payment has to be made.

As expected, middle and low-income consumers expressed the highest level of dissatisfaction. They are dependent upon non-bank credit providers and would prefer to deal with banks and mainstream credit providers. Nevertheless, great frustration is also expressed with the treatment received from these “reputable credit providers”.

In the current legislation, disclosure prescriptions focus mainly on the contract. However, consumers indicate that the signing of the contact is largely a formality, and that a great majority of them hardly read it. Amongst the small minority that do attempt to read the contract, the responses indicate a limited understanding of the terms and conditions and a perception that the contracts are one-sided, with ample provision for credit providers’ rights and little attention to consumer protection. The implications are two-fold: (a) that much more attention should be given to disclosure in advertisements, brochures and marketing material, and (b) that there is a need for increased standardisation of contracts, or at least for prohibition of one-sided contracting terms.

Consumer responses indicate unambiguously that a “buyer beware” approach is not appropriate. When applying for credit, consumers are frequently desperate and not in a position or frame of mind to contest the contents of the contract. The fear of the application for credit being turned down, which is linked to the fear of being blacklisted, places the consumer in a highly vulnerable position when applying for credit.

Disenchantment, and even fear, was common in respect of “zero deposit deals” (HPs); deals with residual balances (car finance) or deals which entail an initial period in which there is no repayment or where the repayments are lower (HP, store card and car finance). Consumers reported having been “caught out” through these terms, that they were generally not well explained, were misleading and that “in the end, the payments will be more”.
Consumer responses across all income groups and products indicate a need for much greater protection in credit legislation, and for improved enforcement of such protective measures.

3.2 Views of industry representatives, consumer representatives and other stakeholders

A separate research project focused on the views of industry representatives, consumer groups, provincial consumer desks and other stakeholders. This research focused on specific areas of the current legislative framework, and market practices.

There was a surprising level of agreement between these disparate groups on a range of issues. These include: -

- The need to replace the current credit legislation with a new Credit Act that should apply consistently across all transactions and to all credit providers;
- The need for much stronger enforcement, with a common view that a lack of enforcement is to blame for a great number of the problems being experienced by consumers;
- The need for some kind of "national loans register" that will ensure credit providers do not extend more credit than the consumer can afford.

In the following table we summarised a range of issues on which the various stakeholders were in agreement.

a) The existing legislation is old and ineffectual and should be replaced with one, consolidated Credit Act; b) Legislative and enforcement weaknesses are contributing to non-compliance and are undermining consumer protection; c) A number of different participants expressed the view that the credit providers which service the low income client base were in general less compliant and less effectively regulated than high income clients; d) The law must be simplified and the definitions and terminology more clearly defined; e) Enforcement is weak and has resulted in extensive non-compliance and circumvention of legislation; f) There should be one consumer credit regulator that should enforce compliance	g) Fees & charges, and credit life insurance in particular, inflate the cost of credit, are used to circumvent the Usury Act cap, and undermine disclosure; h) Greater honesty by consumers in disclosure of existing debts would be of benefit to both the consumers and the credit providers; i) Consumers must read their contracts and understand their commitments; j) It is important that consumers be better educated in credit issues; k) There is a need for a national register of loans and other commitments; l) The data on the existing credit bureaux are inaccurate.

across all the different types of consumer
credit transactions;

- *Rudo Research & T raining. A Market Research Report: Credit Law Review, 2002*

On areas such as the standard of compliance amongst banks, the value of credit bureaux and the need for an interest rate cap there was less agreement.

4 Research: Statistical & Economic Analysis

4.1 Size of the market

The consumer credit market encompasses a range of products from mortgages, car finance, and credit cards, through to instalment sales (hire purchase), store accounts and micro-loans. The total value of consumer credit facilities was estimated at R361 bn, consisting of approximately 20 million accounts (as at September 2002). The relative size of the different sub-sectors of the market, and the number of transactions in each sub-sector, are summarised in the next table.

	No. of Accounts (millions)	Size of Book (billions)	%
Mortgages > R100 000	1.03	R 156.80	42%
Mortgages < R100 000	1.00	40.00	11%
Overdrafts & other loans	5.50	69.30	18%
Pension backed loans (banks plus pension administrators)	1.00	2.50	2%
Leases	0.32	10.40	3%
Instalment Sales	3.35	53.90	15%
Credit cards (incl. Store credit)	5.20	19.1	6%
Micro loans (non-banks institutions, registered)	2.10	7.30	2%
Micro loans - other	1.00	1.80	0%
	20.50	**R 361.20**	
Source: SARB & estimates, per P.Hawkins			

Mortgages alone account for more than 50% of all consumer credit, with overdrafts and loans (18%), and instalment sales (15%) being the other big categories.

Note that credit provided to companies and legal entities is excluded from the amounts provided above. Total non-household or corporate credit exceeds R366bn, with the main categories being overdrafts and loans (71%) and mortgages (15%).

4.2 Profile of credit usage

There are marked differences in the profile of the clients who use these products. For instance, mortgages, credit cards and overdraft facilities are mostly accessed by middle and high income consumers while micro-loans, store cards and instalment sales are predominantly used by lower income consumers[3].

The following table provides an approximation of the types of credit products, and the total volume of credit, to which different income groups have access.

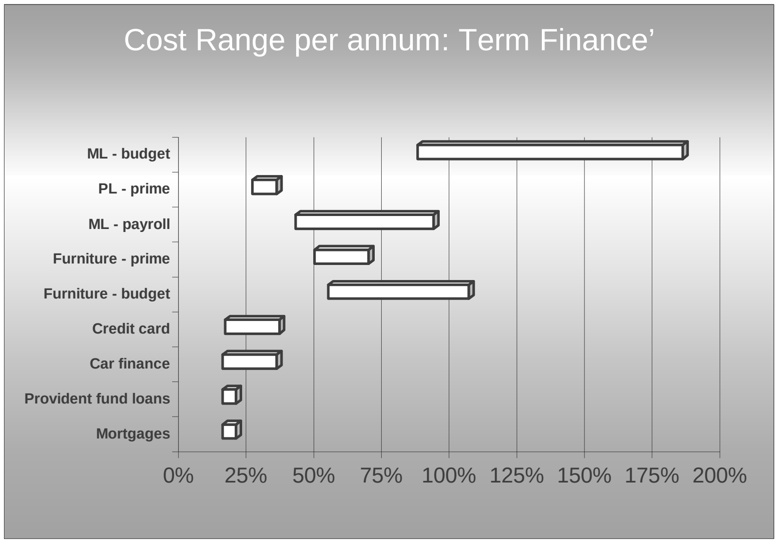
[3] Note that the instalment sale amount includes certain vehicle finance contracts.

Living Standard Measure	Number of households	Average annual household income	Products
LSM 1, 2 & 3	2,704,000	10,695.59	Micro-loans and restricted access to Store cards & Instalment sales
LSM 4 & 5	2,215,000	21,877.90	Store cards, instalment sales & micro-loans
LSM 6 & 7	2,281,000	65,136.57	All of the above, with limited credit cards and mortgages
LSM 8	1,279,000	157,308.00	Credit cards, overdrafts, personal loans, car finance & mortgages.

Approximately 75% of consumer credit consists of products that are predominantly used by the high-income groups (consisting of approximately 15% of the population). The low and middle-income groups (85% of the population) use about 25% of the consumer credit, consisting of products with an aggregate value of *approximately* R95bn. These products consist primarily of micro-loans, store cards, hire purchase and loans backed by provident fund guarantees.

4.3 Cost of Credit

The following graph provides an indication of the range of costs for different types of credit products.



At the extreme are one-month loans (which are excluded from the table above), which generally cost 30% per month (360% per year), although certain suppliers are offering one-month micro-loans at 17%, 22.5% and 25% per month.

The cost of the term finance is measured as the total cost to the client, inclusive of credit life insurance and all compulsory fees and charges. Research has revealed the following interest rate bands: -

- The cost of mortgages and loans secured against provident fund benefits vary from about 2% below prime, to about 2% above prime;
- Consumers who have prime mortgages could obtain vehicle finance at the same rates as their mortgages (or slightly above), and could obtain credit card finance and even store credit at rates varying from prime rates to the Usury Act cap (about 29% p.a.);
- Clients *other than "prime clients"* can obtain vehicle finance and personal loans at rates of up to approximately 35% p.a.;
- The cost of furniture finance for "big ticket items" varies between 40% and 70% p.a., while the cost of finance for smaller items (below R10, 000) varies between 50% and 100% p.a.;
- The cost of payroll deducted micro loans varies from about 40% to about 90% p.a.;

- Term micro-loans vary from as low as 35% to as high as 185% p.a. Lower charges apply where loans are secured against insurance policy settlement values and where clients with high credit criteria are "pre-screened". Higher charges apply to unsecured personal loans with more limited credit risk assessment.

It is clear that in certain market segments *the cost of credit is very high*. The conclusions and inferences as to the factors drive these interest rate patterns are assessed in the next section. Prior to that, a number of observations are made about the profile of the consumer credit market.

Profitability: The research indicated that there does not seem to be a high correlation between the cost of credit to the consumer, and the profitability of the entities that provide such credit. This seems to be true for micro-lenders, retailers and banks.

Rejection rates: Rejection rates reported by lenders could be as low as 10% and 30% for products such as high value mortgages, pension backed loans, and payroll deducted loans. It could also be as high as between 70% and 80% for store credit and certain types of micro-loans. The rejection rates reported by providers suggest a high degree of unsatisfied demand, particularly at the low end of the market, where appropriate security is not available. It may also indicate that a substantial portion of the potential client base is under-serviced.

Client selection: In general, high bad debt ratios appear to correlate with poor screening of clients and attempts to win market share. The poor screening may be seen as a consequence of incomplete and inadequate information (see comments in the next section), and can potentially be addressed by broader information sharing between lenders and the creation of a national pledge register. While efforts to win market share may encourage imprudent behaviour by credit providers, there is a tendency by suppliers to withdraw once their fingers have been burnt. This may be seen as an evolutionary phase in the credit market. Unfortunately, it may leave over-indebted clients in its wake.

4.4 Efficiency of the Consumer Credit Market

It seems valid to conclude that the *consumer credit market is very inefficient*, whether in terms of:

- High cost to consumers not translating into high returns for suppliers;
- The fact that high returns do not attract new entrants, thus not increasing competition and not leading to lower prices;

- The inability of banks and other large credit providers to successfully enter the low income market

- The inability of suppliers to evaluate or accurately price for risk, or;

- The inability of the market to evolve in a manner that would give low income consumers access to low cost distribution channels or other benefits of economies of scale.

Thus, while sophisticated risk management and information technology is available, together with a relatively developed capital market that could provide loan capital, the cost of credit is exceedingly high in certain market segments. At the same time, the supply of credit in certain segments appears to fall substantially below the demand. These factors appear to point to dysfunctionality in the consumer credit market.

4.5 Factors that distort credit allocation and increase the cost of credit in certain market segments

In the course of the Credit Law review, and the specific research into the economic factors that have an impact upon the credit market, a number of factors were identified, each of which distorts the efficiency of the credit market and leads to inefficiency in the allocation of credit or causes the cost of credit to be higher than it may otherwise be.

In summary, these factors are: -

Usury Act Cap: The Usury Act interest rate cap has been in place for nearly a century. This appears to have divided the market into two sub-markets, which function very differently. Below the cap, the interest rate is a good indicator of the cost of credit and many large and reputable credit providers are competing for market share. The second sub-market consists of virtually any type of credit where the client is not a 'prime client' or does not have very good security to offer. The cap does not allow the provider to cover its operational cost, the perceived risk and a sufficient margin. The credit provider thus adds to the income by charging credit life insurance and various other fees. The actual cost could thus be substantially more than the interest rate and is not transparent. In the Usury Act Exemption category the cap does not apply and government attempted to improve disclosure by defining "the annual rate for the total cost of credit". However, it is perceived as a high-risk market (including high reputational risk) and lenders are reluctant to enter this market or to make substantial operational investments. *There is thus a clear* *segmentation between the market in which 'prime clients' obtain credit, and the credit market(s) for other clients, with the former being actively contested, competitive and fairly well disclosed. The latter is typified by weak disclosure and limited competition on the price of credit.*

Disclosure: Weaknesses in the disclosure rules imply that the actual cost of credit is frequently much higher than the disclosed interest rate. This undermines the consumer's ability to make informed choices and relieves the pressure on suppliers to reduce interest rates.

Legislative deficiencies & uneven enforcement: Ineffectual disclosure rules allow for substantial circumvention of the Usury cap. The enforcement of the Usury Act and Credit Agreements Act has been both ineffectual and unequal between different providers and products. Through lack of enforcement, the practices of less scrupulous providers have become the norm. As a result, the non-prime market operates in an oblique manner with little effectual or transparent competition[4].

Credit risk information: Current credit information exchange is fragmented and incomplete. Credit bureaux exclude information on substantial and important parts of the consumer credit market, while the information on the bureaux is frequently inaccurate. This undermines the credit provider's ability to identify non-creditworthy consumers; leads to high levels of bad debt and thus to increased cost of credit across the board.

Court orders: The current requirements for the granting of court orders (e.g. garnishee orders or emolument attachment orders) are such that the court does not consider whether the credit provider 'acted responsibly' prior to issuing a court order court order. This creates an incentive for creditors to act recklessly, or to extend more credit than what a consumer can reasonably repay, given that the credit provider assumes that it will be able to obtain a court order if the consumer defaults. Court orders do not differentiate between reckless and responsible credit providers, and the actions of the 'reckless credit provider' creates an added risk for the more cautious credit provider, or a provider of long term or large amounts of credit, implying that the latter are inclined to withdraw from the non-prime markets[5].

Predatory behaviour in certain market segments: The factors mentioned above contribute to reckless and/ or predatory behaviour by certain credit providers. This increases the overall risk in the consumer credit market and thus contributes to higher cost of credit to all credit users.

[4] There may well be substantial *non- price competition*, e.g. on cost and features of the products or services that are provided on credit, *but little competition on the cost of credit.*
[5] I.e., withdraw based upon *the risk imposed by the manner in which the market operate* (the inefficiency and dysfunctionality of the market, rather than due to the client's risk profile per se.

Competition: The research identified a number of mechanisms through which credit providers can avoid or can *limit competition on the price of credit.* These include payroll deductions, collection through 'preferred debit orders' and collusion between different parties that are involved in the broader consumer credit industry. The many weaknesses in the competitive environment imply that different suppliers do not compete on the price of credit, and thus that there is little pressure from consumers to reduce interest rate and related charges.

Mortgages: Clients with high value mortgages in prime locations have access to various products and can shop around. Outside prime areas (and in township areas in particular), the housing market is ineffectual and mortgage finance is generally unavailable. Problems in housing registration and housing transfer contribute substantially to this state of affairs. A large majority of the population can thus not benefit from what should be their best security - their mortgage - and faces generally high cost of finance. This population's investment in housing stock does not translate into the creation of "securable assets"[6] and asset accumulation is undermined.

Banks Act: The Banks Act conditions for a banking licences limits entry into banking and thus limits competition and innovation, both of which contribute to higher interest rates. The Banks Act constraints on non-bank credit providers on raising loan capital[7] also limits non-bank credit providers' ability to expand and make the market more competitive.

National Payments System (NPS): The research indicated that there are various arrangements or fee structures related to the NPS and banks' transaction processing that are excessive and biased against small or short term transactions; that directly *add to the cost of credit* and that contribute to *limiting competition* in the provision of credit. In addition, unequal access to the payments system for different credit providers, e.g. preferences enjoyed by certain participants, increases the uncertainty and risk of many credit providers (and non-bank credit providers in particular) and contributes to increasing the cost of credit to the consumer.

Regulatory uncertainly: In a number of areas there is a very high level of regulatory uncertainty. This includes the future of the Exemption Notice, the future approach to interest rate regulation and the treatment of credit life insurance. Given such uncertainty, credit providers tend to take a short- term view. This inevitably leads to an increase in the cost of credit.

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[6] Instead it becomes "dead assets", in Hernando de Soto's terminology (De Soto, Hernando. Mystery of Capital. Bantam, 2000.).

[7] Refer the exclusions from the definition of 'business of a bank', sub-sections i and ii(ee), as well as the pre-conditions for issuing corporate paper (e.g. the minimum size of an issuer).

The nature and scope of the research did not enable conclusions on the relative magnitude of the impact of each factor. However, it does appear as if the combined impact of these different factors, viewed together, goes a long way towards explaining the inefficiency and dysfunctionality of the consumer credit market.

5 International Benchmarks

During the course of the review of the regulatory framework for consumer credit, regulatory approaches and consumer credit legislation of a number of countries were assessed. These included Australia, New Zealand, England, Canada and the European Union's consumer credit directives. Enquiries were also made into developing country benchmarks, but the conclusion was that the regulatory frameworks in most of the *developing countries* were either fragmented or dated and not appropriate in a credit market as sophisticated and complex as South Africa's.

Many of the countries used as benchmarks reviewed their consumer credit legislation in the early 1990s. Australia also conducted follow-up assessments and amendments. By comparison, South African consumer credit legislation has lagged behind.

Many of the concerns raised in the South African debate on the regulation of consumer credit have also been raised in these benchmark countries. Some of these are:

- Improved disclosure of the cost of credit, in order to enhance the consumer's ability to make informed choices;
- Improved regulation of credit life insurance, in order to prevent this from being used to inflate the cost of credit;
- A number of countries are giving attention to over-indebtedness, and are considering rules that would enhance responsible lending practices and curb reckless sales and marketing techniques;
- The importance of credit bureaux are increasingly recognised, as is the role that it can play in combating over-indebtedness; and
- The importance of effective competition in the credit market.

As part of the Credit Law review, a comparison was made of the detailed legislation on different aspects of the consumer credit. The regulatory approaches adopted or being considered in these countries were taken into account in developing this policy framework.

The policy proposals should ensure that the South African regulatory framework for consumer credit complies with the following criteria from the United Nations' Guidelines for Consumer Protection: -

- To encourage the development of market conditions that provide consumers with greater choice at lower prices, taking into account that consumers often face imbalances in economic terms, educational levels and bargaining power.

- To promote and protect the economic interests of consumers;

- Providing access to consumers to adequate information to enable them to make informed choices according to individual wishes and needs;

- Provide effective consumer redress;

- Provide protection from contractual abuses such as one-sided standard contracts, exclusion of essential rights in contracts, and unconscionable conditions of credit by sellers; and

- Provide appropriate consumer education and information programmes covering credit conditions.

6 Primary Objectives of a Regulatory Framework

The review identified the following as primary objectives for consumer credit regulation: -

a) Improve consumer protection;

b) Ensure consumer credit law supports national objectives and in particular, Black Economic Empowerment and SMME growth.

c) The review should be consistent with international standards.

Therefore credit legislation should: -

i) Promote adequate disclosure by credit providers;

ii) Prevent fraud or other unfair practices by credit providers;

iii) Prohibit anti-competitive behaviour such as collusion or monopolisation;

iv) Promote and protect the economic interest of the consumers;

v) Improve consumer education;

vi) Ensure effective consumer redress;

vii) Create compliance monitoring mechanisms, penalties for non-compliance and complaints resolution mechanisms;

viii) Ensure consistency between the regulatory framework for consumer credit and related legislation, and consistency with the broader framework for financial regulation;

ix) Improve the regulation of the marketing and sales of consumer credit, and the regulation of agents and brokers;

x) Introduce regulation on collection practices such as payroll deductions and banks' treatment of debit orders (and strengthen the regulations against retention of bank cards and PiNs) in order to ensure that neither competition nor consumer protection are undermined;

xi) Ensure protection of the credit information of consumers as well as the accuracy of the information. Implement appropriate regulation for credit bureaux in order to ensure greater but more responsible information sharing, better risk assessment and greater access to finance. *Ensure that credit bureaux can function as a credible information base that could be used to minimise over-indebtedness*;

xii) Introduce mechanisms to protect consumers against over-indebtedness, to introduce penalties against reckless and predatory credit provision and to compel credit providers to perform affordability tests prior to the approval of credit facilities;

xiii) Introduce legislation to ensure that debt counselling and debt rehabilitation services are available and accessible nationally, and to ensure that real assistance can be provided to over-indebted consumers;

xiv) Revise the approach to interest rate control in order to ensure that it does not distort the market, that it does not pose an obstacle to low cost housing and SMME finance, *whilst ensuring* that there are mechanisms to deal with price manipulation and anti-competitive market practices;

xv) Improve the Magistrates' Court Act debt collection procedures and modify procedures that engender reckless lending behaviour;

xvi) Improve the environment for security-based lending.

7 Initial Thoughts on a New Policy Framework

Based on the Technical Committee's research and the discussion of a range of options and alternatives, a number of changes are proposed to the regulatory environment for consumer credit. These are summarised below.

Summary of the proposed regulatory framework: -

i) The Usury Act and Credit Agreements Act should be replaced with a new Consumer Credit Act.

ii) A Consumer Credit Regulator should be established, as an independent regulatory body directly accountable to Parliament, to license credit providers, monitor compliance and enforce the Consumer Credit Act.

iii) Consumer protection should be improved through appropriate provisions in the Consumer Credit Act, which should (a) improve disclosure of the cost of credit and of the terms of credit agreements, (b) should extend both to credit contracts *and to advertising and marketing material*, (c) prohibit undesirable credit terms and undesirable practices, and (d) regulate the behaviour of agents, brokers and other intermediaries.

iv) Consumer education should be improved through implementation of an integrated national programme of consumer education provided through the Consumer Credit Regulator, provincial government and non-governmental organizations.

v) Consumers' access to redress should be improved by implementing a nationally accessible complaints resolution and debt- counselling framework. The National Government and the Consumer Credit Regulator should work with the Provincial Government Departments in order to establish complaints resolution and debt counseling capacity within the Consumer Desks and advice centres in each province.

vi) Protection against over-indebtedness should be improved by introducing provisions on reckless lending in the Consumer Credit Act.

vii) Through the Consumer Credit Act, all areas of Credit Bureau activity and the exchange of consumer credit information between credit providers and any other parties should be regulated.

viii) In co-operation with the Department of Justice, the weaknesses in the regulation of debt collection and in the legislation that governs security offered against consumer credit should be investigated and improvements introduced. The aims should be (a) to remove incentives for reckless behaviour, (b) to consolidate & simplify legislation on security and (c) to assess the feasibility of introducing a "register of collateral".

8 Assessment of Consumer Credit Policy Against National Policy Objectives

The proposed revisions to the regulatory framework for consumer credit should be supportive of national policy objectives. The following are *the* primary areas in the President's *Integrated Action Plan* that would be furthered: -

- *Growth and employment* would be enhanced by a more effective credit market. Better allocation of credit would stimulate domestic demand and would ensure that domestic demand better reflect consumer preferences. This would facilitate an improvement in allocation of resources towards areas that are consistent with consumer preferences. Furthermore, the removal of the distortions that are introduced by the current legislative weaknesses would enhance economic efficiency.

- Removal of the distortions that are caused by current legislative weaknesses, would also *improve the geographic spread of economic activity and employment*. The current legislative environment and the bias that it has towards large credit suppliers, creates a strong incentive for further concentration in the areas where such large suppliers are located.

- *The competitiveness* of the *financial services sector* could considerably improve as result of the proposed regulatory changes. Weaknesses in the current legislation and in the regulatory environment have allowed anti-competitive market practices to mushroom, to the benefit of uncompetitive suppliers. It has thus allowed credit providers to avoid competition. For instance, inadequate disclosure has undermined competition between financial service providers while allowing retailers to arbitrage between the prices of retail goods and cost of credit. These factors have undermined consumer choice and have thus also undermined competition in both the retail credit and retail sales and production markets. Credit life insurance and credit related fees and charges have had a similar impact on the credit market and on the banking sector. The proposed changes in the regulatory environment could thus have a significant impact upon the competitive environment.

- *Small Business Development* would benefit, primarily through increased access to finance. There is ample evidence that the existing regulatory weaknesses have distorted the allocation of finance, and that small businesses have been among the primary losers. Increased competition and increased efficiency should over the medium term also be of benefit in reducing the cost of finance.

- *Black Economic Empowerment* is potentially one of the largest potential beneficiaries of the proposed regulatory changes. Improvements in the access to personal finance, in the disclosure of the cost of finance, improved protection against over-indebtedness and new mechanisms to assist those who experience debt problems are all designed to assist consumers, and previously disadvantaged consumers may well be the largest beneficiaries. Credit plays an important role in the ability of consumers to accumulate assets and improve their living standards, and black consumers are most negatively impacted upon by the current inability to access finance and the high cost of finance. The dangers associated with over-indebtedness or with injudicious use of credit could equally undermine black empowerment. The proposed regulatory changes are designed *on the one hand* to support the development of a consumer credit market that would be of benefit to the consumer, *while on the other* to provide protection against over-indebtedness and assist consumers who over-extend themselves. All of these changes would be of major benefit to black South Africans.

9 Other Legislation Impacting Upon the Consumer Credit Market

These policy proposals focus on the consumer credit market, and in particular on the regulation of consumer credit. However, through the course of the research that was undertaken as part of the Credit law Review, it has become abundantly clear that the Consumer Credit Market is inter-linked with other financial markets, other areas of financial regulation and the broader environment of legal recourse and contract enforcement.

Amongst these, two areas stand out. The first is the disadvantaged position of non-bank credit providers, and the impact that this has on low- income consumers. It is of great concern that low-income consumers and small and micro-enterprises are denied access to bank credit and are consistently relegated to non-bank and marginal credit providers. It is similarly of concern that, despite the above, these non-bank credit providers face major obstacles in accessing capital or in being registered as banks, while they are also being discriminated against in recovery of repayments (through bank debit orders and the national payments system). The Policy Board for Financial Regulation has already identified these problems and is formulating proposals to address aspects thereof. These include the registration of “core banks” and “second tier banks”, and improvement in the access to capital for non-bank credit providers. *These are very important, as any factor that increases the cost and decreases the competitiveness of non-bank financial institutions, also impacts negatively upon their primary client base, being the low-income population.*

The second area is the weaknesses in the legal mechanism for contract enforcement, for debt recovery, for access to court orders (garnishee orders and emolument attachment orders) and weaknesses in the legislation on 'loan collateral'. The research highlighted many of the negative consequences of these factors: (1) These weaknesses inhibit the development of secured finance products, and thus prevent low income consumers and small businesses from benefiting from what may be the least expensive forms of finance. (2) The <u>*problems in the area of debt recovery and contract enforcement increase the cost of finance substantially*</u>. (3) These problems weaken the position of consumers and undermine consumer rights. (4) They also undermine the development of the credit market (and create disincentives for credit providers), in exactly those areas that are most important for low-income consumers. Many of these problems had been identified in various investigations by the Law Commission and **the dti** (including the Ntsika Report on Business Regulation). The Technical Committee want to highlight the importance that these areas be addressed and the potential benefit of reform in the credit law will be undermined if these problems remain.

Apart from these legislative issues, it has become clear that neither the cost nor the access to consumer credit or SME finance will improve substantially and in a sustainable manner if there is not <u>*more effective competition*</u> between banks, and between bank and non-bank credit providers. This is the key to sustainable improvement in the access to finance and a lowering of the cost of finance.