

# **LITERATURE REVIEW ON THE IMPACT OF THE NATIONAL CREDIT ACT (NCA) HAS HAD ON SOUTH AFRICA'S CREDIT MARKET**



**FINAL REPORT**

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## Acronyms

ADR	-	Alternative Dispute Resolution
APR	-	Annual Percentage Rate
BASA	-	Banking Association of South Africa
BC model	-	Business Correspondent model
BEE	-	Black Economic Empowerment
Big 4 Banks	-	Absa Bank Ltd, Firststrand Ltd, Nedbank Ltd & Standard Bank Ltd
BRICS	-	Brazil, Russia, India, China, South Africa
CAS	-	Credit Authorisation Scheme
CGAP	-	Consultative Group to Assist the Poor
CIBIL	-	Credit Information Bureau India Limited
CPA	-	Consumer Protection Act 68 of 2008
CPA(2)	-	Credit Providers Association
CRR	-	Cash Reserve Ratio
DCASA	-	Debt Counsellors Association of South Africa
DCCBs	-	District Central Cooperative Banks
DFIs	-	Development Finance Institutions
DTI	-	Department of Trade and Industry
ECRC	-	European Coalition for Responsible Credit
FAIS	-	Financial Advisory and Intermediary Services Act 37 of 2002
FIPs	-	Financial Inclusion Plans
FIs	-	Financial Institutions
FLCCs	-	Financial Literacy and Credit Counselling Centres
FSB	-	Financial Services Board
FSDC	-	Financial Stability and Development Council
GCC	-	General Credit Card
IMF	-	International Monetary Fund
KCC	-	<i>Kisan</i> Credit Card
LOA	-	Life Offices' Association (long term insurance)
LSM	-	Living Standards Measure
LTCCs	-	Long Term Cooperative Credit Structure
MFIs	-	Micro Finance Institutions
NABARD	-	National Bank for Agriculture and Rural Development
NBC	-	Net Bank Credit
NBFCs	-	Non-Banking Financial Companies
NCA	-	National Credit Act 34 of 2005
NCR	-	National Credit Regulator
NDMA	-	National Debt Mediation Association
NDTL	-	Net Demand and Time Liabilities
NOF	-	Net Owned Fund
NPAAs	-	Non Performing Assets
PACS	-	Primary Agricultural Credit Societies
PCARDBs	-	Primary Cooperative and Agricultural Rural Development Banks
PDAAs	-	Payment Distribution Agencies
PDASA	-	Payments Distribution Association of South Africa
RBI	-	Reserve Bank of India
RIDF	-	Rural Infrastructure Development Fund
ROSCAs	-	Rotating Savings and Credit Associations
RRBs	-	Regional Rural Banks
RUDSETIs	-	Rural Development and Self Employed Training Institutes
SAIA	-	South African Insurance Association (short term insurance)
SARB	-	South African Reserve Bank
SCARDBs	-	State Cooperatives and Agricultural Rural Development Banks

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SHG –BL	-	Self Help Group Bank Linkage
SHGs	-	Self Help Groups
SIDBI	-	Small Industries Development Bank of India
SLR	-	Statutory Liquid Ratio
SMEs	-	Small Medium Enterprises
SSI	-	Small Scale Industries
STCBs	-	State Cooperative Banks
STCCS	-	Short Term Cooperative Credit Structure
UCBs	-	Urban Cooperative Banks

# 1 EXECUTIVE SUMMARY

## 1.1 Introduction

The *credit industry* is a large and complex environment, hence it is not surprising that new legislation will bring to the fore the various viewpoints of stakeholders in this industry, which are influenced by the role they fulfil within the credit value chain. The NCA does not necessarily have conflicting objectives but objectives, which will have to be weighed against each other, specifically when it comes to providing maximum access to credit within society, but simultaneously alleviating the burden that high indebtedness puts on our economic and social systems.

## 1.2 Emerging themes

We have highlighted a number of emerging themes that are surfacing across the areas of research which include the regulatory and legal environment as well as views of direct stakeholders i.e. the consumers, credit providers, payment distribution agencies, debt counsellors as well as all associations formed by these to address the challenges faced in terms of successfully implementing this legislation.

The following themes have emerged around the main tenets of the legislation as well as the implementation and interpretation of these; and they form the basis of our conclusions and recommendations:

- Reckless lending as a very powerful concept of the NCA seems to have limited impact in the day to day working of the legislation.
- Shopping around for the best deal is not as easy as intended due to a lack of standardisation, limited implementation and a negative impact on credit scoring because of the multiple enquiries at credit bureaus.
- The debate around maximising access to credit versus combating the high level of indebtedness in South Africa has many aspects. Research often presents a specific perspective on one of the aspects rather than providing a fully holistic view. Research will have a specific focus area, clearly to ensure questions are answered, but it is important to challenge the assumptions and conclusions as they will have to be considered in the broader context.
- Consumers are creating additional dynamics to the system by reacting to the opportunities the legislation has presented and use these to their advantage.
- The credit system, specifically the debt counselling environment with debt counsellors, voluntary resolution via the NDMA, alternative debt resolution channels, credit and banking ombudsmen as well as legal channels is complex and not all that transparent to consumers.
- Regulation and standardisation based on compulsory rulings and voluntary engagement of stakeholders still requires significant expansion.
- Access for low income earners to credit as well as the remedies of the NCA remains a challenge. Credit providers, debt counsellors and Payment Distribution Agencies are all commercial institutions and unfortunately the smaller size loan, or very limited repayment abilities, makes these low income earners not attractive from a business point of view to the credit providers. They rather deal with higher income consumers that give them a better return on the same amount of effort.

## 1.3 Legal and compliance

In the review conducted, we looked at various legal and compliance aspects relating to the NCA. It is clear that a lot of discourse took place around understanding the legislation, which resulted in research being commissioned and recommendations for change and clarification being made. Legislation was not amended, so the courts have been the route to resolve any of the points that were not clear in the NCA. This may have led to a certain disjunct with the original intentions of the legislator. One example of this is the utilisation of the Section 129 letter, where the credit provider informs the consumer of its intention to take legal action and points out the *debt review* option, but in terms of the current court rule, once the letter is issued, the road to debt review for that specific debt is no longer accessible.

The debt counselling process as a new concept could do with more detailed guidance on a number of procedural aspects, standardisation of forms and a sharpening of entry criteria for debt counsellors.

The interaction between the NCA and Insolvency legislation is explored as courts began considering whether remedies of the NCA had been utilised before voluntary sequestration was applied for. It is noted that legislation could have benefited from a level of alignment between both Acts as it is missing part of the ultimate debt resolution. The NCA, unlike the Insolvency legislation, does not provide any option for a court to cancel (part of) debt and follow a rehabilitation process akin to the insolvency process. Therefore, whilst the NCA aims to restructure debt, it cannot set aside part of it in order to make the restructure work (it only has the ability to set aside debt that is deemed reckless).

At face value, the *reckless lending* provisions seem a very powerful tool of the NCA in terms of preventing consumers from getting into too much credit in the first place. The sanction for the credit provider is quite steep as reckless agreements could be set aside completely and become unrecoverable, hence it should deter this practice. However, disclosure by the client is the key defence here and there seems to be little obligation on the credit provider to verify information. Hence, the recourse to reckless credit provision has been rather limited in spite of some high profile cases that the media highlights. It seems that the Banking Ombud had a number of reckless lending cases presented on which it did rule in favour of the consumer. It is noted that proving reckless lending is not all that easy and the feedback from debt counsellors is that the potential upside does not outweigh the damage done to their relationship with the credit providers when trying to access this route. It therefore seems more beneficial for all parties to work towards debt restructuring.

The manner in which sureties to credit agreements under the NCA access the remedies of the NCA is also noted as an important point because the credit assessments tend to focus on the main borrower and it is clear that the wife or child that credit guarantees a loan is subject to the same standard. When they are not in a position to serve the debt, the access to the collateral they may hold, which is usually the reason for such a suretyship, can be attacked under the NCA.

The Banking Association's annual report indicated in 2009 that as few as 5% of the estimated 150 000 applications were finalised by the courts. The objective of the NCA for restructuring consumer debt in order to *normalise* a consumer's debt situation in the most effective way is certainly far from being met.

Significant strides have been made in the implementation of the NCA which are evident in the literature since June 1, 2007. Court cases have clarified interpretations, stakeholders have organised themselves into associations and reached agreements around codes of conduct. Significant review in the debt counselling process has led to engagements to improve this newly established function in the credit industry, which includes the establishment of alternative and voluntary processes that can be followed by consumers.

With time, the debate has become more granular, more detailed and more focussed on solving challenges and improving process rather than just levying criticism.

The two points that need to be stressed with regard to the legal framework are as follows:

- A review of the legislative framework is still required based on some of the detailed input provided in the NCR commissioned research given the fact that not all these matters have been clarified by court orders; and also for the matters that have been the subject of declaratory orders, it is not fully evident that these rulings match the original intention of the legislator.
- Engagement with the judiciary has to happen around an approach to clear the backlog in the system regarding debt review and restructure. This will require a significant intervention, but it is key in dealing with the currently highly stressed consumer debt situation.

On a forward looking basis, the first step should be to map out all the avenues that a consumer can follow, because they can easily get lost in the myriad of options for different challenges around credit agreements. Alternate debt resolution should be advocated as a first choice and not debt review. Our research has shown that no-one has published that road map to the consumer. This should be done as a matter of priority.

## 1.4 Institutional impact

Our analysis around institutional impact looked at the three categories of registrants with the NCR which are:

- credit providers;
- credit bureaus;
- debt counsellors; and
- payment distribution agencies, who whilst not within the NCR's regulatory scope, are crucial participants in the debt restructuring process.

The impact on credit providers has two aspects. Firstly, the financial impact of compliance to the Act is significant in direct and indirect cost terms. Processes from granting of credit through to the ultimate recovery, have added complexity to them. The level of credit granting has been constrained by the provisions of the NCA to promote responsible lending, fee and interest rates have been capped, hence reducing the top line revenue on this.

One could argue that this is offset by the positive impact of a reduction in risk which leads to lowered cost of default, and improved return on capital held to cover such risk. The indication though is that it is a net negative impact to the credit provider.

Debt counselling had a significant impact on a number of aspects. The credit providers had to build infrastructure to interact with the debt counsellor. As a result, they established the NDMA as a collective approach and body to interact with other stakeholders, whilst also providing alternative debt resolution via this organisation.

Credit bureaus are a key enabling service in the NCA and the provisions that allow consumers to query and challenge their records are important consumer rights. Apart from the initial uplift in queries after the extensive marketing campaigns in the initial time of the implementation of the NCA, the level of enquiry is still very low. Whilst now, accessing one's credit records is free by law, it is not as easily accessible as it should be.



Data privacy legislation once promulgated, will impact the credit bureaus further as well as its relationship with the consumer and credit provider. It is likely to change consent process, and this may become more onerous. The question is whether the consumer will benefit from this considering the fact that not consenting to the credit check effectively will most likely result in a decline of the credit altogether.

Debt counsellors are a new industry established as a result of the NCA. They are tasked to assist consumers with the non-trivial rearrangement process around their debt situation. Their responsibilities require significant negotiation skills both with consumers unwilling to let go of their standard of living, and with credit providers who are not always willing partners in this process. The changes in the process due to court rulings have increased the burden on debt counsellors and it is noted that a significant level of legal skills is required to successfully fulfil this role. In this context, many smaller operators in this space have ceased operations.

The cost of debt counselling is carried by the consumer, and we note that due to lack of commercial viability as *debt counselling clients*, the most vulnerable consumer loses out in access to this process.

Once agreed in a debt restructure plan, Payment Distribution Agencies are the utilities managing the consumers' payment plans. These agencies are not regulated by the NCA, seemingly an oversight of the legislator, but they do engage with all stakeholders and the NCR. This engagement is focussed on managing the hand offs in the debt review process. However, given the increasing stream of funds into these payment utilities, financial oversight will become a necessity.

Credit providers, debt counsellors and Payment Distribution Agencies all have codes of conducts supplementing the legislative frameworks. It is noted that debt collection on the other hand is ignored within this framework of enforced and industry driven regulation. Furthermore, their code of conduct is more prohibitive by curbing excesses in the industry rather than having the hallmark of a positive code regulating good business practice.

Lastly, we had a look at the inclusion of juristics in the ambit of legislation which gives small businesses very limited protection under the NCA. The objective of this inclusion is not clearly defined and hence measurement of impact is not possible. It is a question for further research to consider whether the inclusion has positive impact on small business, or, if the inclusion and a potential lack of understanding of the rules by credit providers is an inhibitor in ensuring access to finances for small businesses.

## 1.5 Credit usage, supply and demand

We used the Feasibility (Pty) Ltd report as commissioned by the NCR: *The cost of credit, access to credit and associated market practices* as a point of departure for this particular part of our literature review.

From a statistical point of view, we used Credit Bureau Monitor (CBM) data published by the NCR as the benchmark for the review, when looking at the impact of the NCA on credit granting, which does have a bias towards the mainstream credit industry in terms of completeness of reporting. We noted that other factors other than the introduction of the NCA, mainly arising from the credit crisis of 2008 and its subsequent impact on cost of funding within the banking/finance industry as well as the resultant pull back on risk appetite by credit providers also have a significant impact on the level of credit activity in South Africa. Therefore, it is not necessarily possible to isolate trends and to attribute these to the implementation of the Act alone.

Mortgage lending has notably dropped ever since the implementation of the NCA. But clearly, there is distinct cause and effect in terms of the credit crisis and the housing market being



significantly depressed. Mortgage lending has become less attractive to credit providers due to a combination of market factors in terms of supply and demand, property prices as well as the cost of funding and acquisition (including bond originations cost) in combination with a changed risk profile attributed largely by the providers, to the length and uncertainty around outcome of the debt counselling process, resulting in changed consumer behaviour around default on their home loans. This has led to a bias towards unsecured lending rather than providing increases on mortgages, specifically within the banking sector.

Recent concerns have surfaced around the increase in unsecured lending and there are varying opinions on this new trend. On one hand, there are indications that banks are pushing clients away from secured credit in favour of unsecured personal loans, and this has caused the regulator to raise concerns about this new phenomenon which needs further investigation. On the other hand, contrary views are being raised. One view was raised by a large micro lender in this field who raised the fact that unsecured lending only relies on the affordability of the consumer without fall-back-on-assets as long as good affordability assessments are being conducted. Therefore, this gives no cause for concern.

In their view, a bubble like the property bubble which was quite massively influenced by a drop in underlying asset value and a lack of demand for property is not likely to recur in a similar form in the unsecured space because affordability is the only driver to the granting of unsecured loans. This is an interesting point because proper affordability assessments are clearly the key premise for successful implementation of the NCA.

One of the objectives of the NCA was to stimulate developmental credit. However, when it comes to the impact of the NCA at grass roots level, research shows many challenges. The first one of these is the ability to measure impact. Statistics and research have a bias towards the formal credit industry specifically the large banks. This is due to their size in terms of market share and the fact that implementation at these institutions including the reporting requirements had the focus and the budget required to enable these. Clearly, these institutions engaged and commissioned their own research around topics of importance to them and also added to the body of knowledge. If this objective is to be met, measurements will have to be defined. Given the lack of current data available, this is an area that would require primary research.

At grass roots level, current data collection is poor both from the reporting into the credit regulator, as well as information collected by independent research commissioned. Trends are hard to track and this gives little direction regarding the alternate routes that enable growth within this market. In spite of insufficient data, it is acknowledged that the traction and increase in access to an extent happened, but has been very low, and that should be addressed further. However, legislation alone may not be sufficient to meet such an agenda.

It should be noted that it is certainly not the ambit of the NCA alone to enable access to credit across the South African economy, and it is not credit legislation alone that drives the (risk) appetite of credit providers to provide loans.

One of the examples is that, in our review, we see researchers looking at the links between the lack of growth in low income mortgages, and the provisions of the NCA e.g. in terms of rate caps and debt review adding cost and risk to the process. However, this lack of growth can similarly be ascribed to what is happening in terms of the development of low cost housing as it may be the lack of willingness by the banks to finance these housing development projects (which loans are not governed by NCA) that drives a lack of housing stock to be financed in the first place. A full view of the factors influencing a particular type of lending would have to be presented because decisions made on certain aspects in isolation will fail to deliver the required results.

So, given that no targets have been set, or perhaps realistically cannot be set around the impact of the legislation in terms of effectiveness, we can only look at the current credit market in isolation to inform a view. In spite of the fact that it is broadly acknowledged that the NCA was a significant contributor to the stability of our economy and banking sector in weathering the global

credit crisis, we are still looking at a heavily indebted consumer population, who are struggling to manage the debt they got themselves into. About 46% of credit consumers have impaired records with an additional 19% of consumers being 1 to 2 months in arrears, leaving less than 40% of consumers that are actually fully up-to-date with their re-payments. A narrow focus on just indebtedness only will also provide an incomplete picture because significant increases in the cost of living have also caused consumers to default on debt that they previously could service.

## 1.6 Effects of programmes and initiatives

As the NCA brought with it the new concept of a debt counselling process, it goes without saying that a significant part of available literature grapples with the challenges around the introduction of debt counselling. The extent to which this process is being accessed by various consumer groups is a good indication of the level of understanding of the NCA by the general public.

A significant piece of work in this area was the 2009 research by the University of Pretoria which was NCR commissioned. We touched on this particular piece and explored further commentary linking back to this publication. The year 2009 was clearly an evaluation point specifically and led to action as outlined in the 2010 report from the Banking Association, regarding establishing oversight and collaborative structures.

It is clear that strides have been made in terms of industry stakeholder engagement to overcome the challenges posed by the implementation of the NCA. It is noted that a certain level of legal framework re-design remains outstanding and will have to be addressed for the country to start realising the full impact of what debt counselling could positively contribute to our industry. Court rulings around the interpretation of the NCA have in certain cases led to a sub-optimal consumer solution.

A lot of work still needs to be done in terms of refining practical aspects around implementation to further foster effective working relationships between stakeholders. Industry stakeholders and the regulator will have to engage with the judicial system representatives to start tackling the challenge of backlog in terms of debt review. Consumers stuck in the system remain indebted and without solutions – which is contrary to the objectives of the Act. Given the myriad of avenues for debt related problems, it is time that the industry writes a road map for consumers on where to go, with which type of complaint and what the different routes to follow for debt resolution, or renegotiation are. Alternative dispute resolution has to become a more significant part of the solution due to the complicated mechanics around debt review as a process.

The impact on consumers, specifically the access of the lower LSM's into the process is an emerging point. There is an unavoidable link back to the level of financial literacy in terms of actually being able to effectively exercise your legislated rights as a consumer.

Finding more creative ways in getting the message out with regard to issues surrounding debt and debt management will be important as certain research indicates a levelling off of awareness, whilst other research does not really point to real trends of growing awareness and understanding. Where increased awareness is noted, it does not show the impact in change of behaviour.

## 1.7 Regulatory institutions and/or other bodies perspective analysis

We have explored the various perspectives of the regulatory institutions around the NCA. Generally, the view of other regulators is one of acknowledgement of the role of the NCR, and the role that the NCA played in the stability of the credit industry during the credit crisis.

Regulators will typically focus on their mandate and in that context we note the view of the SARB on the increase of unsecured lending by the main banks, which has been rather subdued as they do not see a systemic risk to the banking industry emerging at this point. The difference in mandate of the NCR clearly sees them being much more concerned around the trend.

The FSB plays a support role in terms of regulating the credit life insurance and other credit protection insurance. Research done by the insurance industry highlights the need for review of the cost of these typically quite expensive types of insurances, and interestingly enough, pushes that towards the ambit of the NCR to look at guiding these practices. From a cost of credit point of view, credit life specifically, is a debating point as it significantly ups the cost. It is argued that credit providers use this to boost the income that is under pressure due to the caps on interest rates which are linked to the repo rate, which currently is at a historic low.

Direct industry stakeholders like the Banking Association, Ombudsmen and the Credit Provider Association are all in support of the NCA. It is noted that the new banking code of conduct is seen as significant in terms of the NCA implementation. It simply endorses the NCA and does not extend the commitments around debt management, counselling etc. any further than what is legislated.

We note specific research being commissioned by the Banking Association in conjunction with the Micro Finance Council, which highlights their concerns around the caps on fees and interest rates as imposed by the NCA, given the relatively low repo rate that drives the calculation of the maximum interest rate levels.

However, it also emerges that specifically around the setting of mortgage lending rates, it may well be the competitive environment that is impacting the price setting and has led to banks not being able to pass on the increased cost of funding to their clients. There are options available to manage interest rate pricing differently; for instance, by limiting price concessions to a certain period, or linking client rates to JIBAR as a rate that would more quickly reflect changes in the funding pricing.

The contention that internationally, pricing is more flexible and allows credit providers to adjust pricing, is not in line with some of our findings that indicate certainly – in Europe, long term fixed rates (up to 20 years) are provided protecting clients around increasing interest rates over the life of a mortgage loan; an option not available to the South African consumer.

The new Twin Peaks model currently under discussion in terms of financial regulation would have significant implications on the management of the NCA. It is not yet clear how the NCR would be impacted in its mandate around non-bank credit providers, debt counsellors, credit bureaus etc. Alignment of handling bank and non-bank credit providers is not without merit, but a micro lender is not a bank and requirements around the execution of compliance aspects may well differ.

Closer alignment with the FSB will provide opportunities to more broadly explore the challenge of financial access as access to credit should not be solved in isolation of other financial access.

The role of the NCR in the financial stability of the system does get acknowledged in this work, which is a good recognition and it may provide for a better platform of engagement. Currently, we clearly see the concerns of the NCR around the growth of unsecured lending not really meeting minds with the SARB's focus on systemic risk – closer alignment may benefit these debates.

## 1.8 Consumer protection

New consumer legislation like the Consumer Protection Act 68 of 2008 and the new Code of Banking Practice as released by the Banking Association for implementation on January 1, 2012, makes specific reference to the provisions of the NCA. Whilst there seems to be an attempt to

avoid duplication of contradiction by way of exclusion clauses where e.g. in the CPA, certain NCA provisions will prevail, there is a complementary aspect to the various pieces of legislation, or governance rules.

The NCA and the CPA are key components of **the dti's** strategy around consumer legislation, replacing historic and somewhat ineffective legislation that had been in place. They are largely in support of voluntary regulation in terms of codes of conducts etc. due to the ability to more quickly adjust to changing circumstances. They further note that the experts in the industry are often best placed to monitor this, rather than regulators per se.

Dissenting voices have definitely been heard around *this really works for the consumer?* A first view gives the consumer a confusing amount of messages from multiple stakeholders, sometimes (seemingly) contradicting each other, of what to do, and where to go, when you are in financial trouble.

Consumers in the current environment remain vulnerable, and it is questioned if legislation around indebtedness alone does provide sufficient cover. If one looks at the root cause of current consumer distress, it is not necessarily the granting of the credit as done at the time in isolation. The problem often is that the debt which historically was manageable is no longer manageable now due to a combination of the rising cost of living and subdued salary increases. Consumers remain largely in financial distress at this point.

## 1.9 Comparative analysis

The World Bank recently published a policy research working paper which looks at the global prevalence of regulation around loan and deposit services. They identified the need for further detailed analysis around the difference between these legislative frameworks. In general, the international research around consumer credit legislation closely links its findings to the importance of financial literacy in the process of ensuring more financial inclusion. A similar point was raised in 2006 in research done for the FinMark Trust locally, where the importance of financial literacy is emphasised and highlighted as an additional need in terms of the introduction of the legislation as this is not seen as a strong point even within the ambit of credit providers.

Comparisons around the level of consumer credit legislation were made with selected countries in Africa and the Far East.

The comparative analysis we performed focussed on credit regulation with regard to consumer protection and emphasis on the importance of financial literacy as a means of ensuring more financial inclusion. Much of the findings on credit consumer protection frameworks in the different countries is based on the World Bank policy research working paper of 2011 entitled *Consumer protection laws and regulations in deposit and loan services: A cross country analysis with a new data set*. The data used in the paper comes from a survey of financial regulators from 142 countries conducted for the annual *Financial Access* by the Consultative Group to Assist the Poor (CGAP) and the World Bank Group in 2010.

Our literature analysis showed across the countries; it is widely accepted that an effective and efficient consumer protection framework generally should include the following tenets:

- laws and regulations governing relations between service providers and users and ensuring fairness, transparency and recourse rights;
- an effective enforcement mechanism including dispute resolution; and
- promotion of financial literacy and capability by helping users of financial services to acquire the necessary knowledge and skills to manage their finances.

Broadly, key insights discerned from the *Financial Access* survey of 142 countries include the following:

- most countries across the world have some form of consumer protection legislation in place, though it often does not include provisions specific to the financial services;
- enforcement powers and monitoring ability of regulators are often limited;
- regulations on financial consumer protections are often recent and many countries are actively reforming in this area with reforms having increased since the beginning of the global crisis of 2008 in both developing and developed countries; and
- in a number of countries, there are number of implementation challenges where the laws assign supervisory and regulatory powers to a number of agencies. (This is the reason why in recent years several countries established a single agency responsible for consumer protection for financial services. Amongst the best known is the NCR and the Financial Consumer Agency of Canada.)

With regard to attempts to increase financial literacy, some countries especially India have adopted National Financial Literacy Strategy designed to achieve the following main objectives:

- create awareness and educate consumers on access to financial services, availability of various types of products and their features;
- change attitudes to translate knowledge into behaviour; and
- make consumers understand their rights and responsibilities as consumers of financial services.

It is widely acclaimed that South Africa was largely insulated from the global financial crisis because of its more rigorous regulatory environment, which governs the extension of credit. The NCA is acknowledged to have gone a long way in ensuring that South Africa was not as seriously affected by global patterns as were many of the world's leading economies.

As a result of this, our literature analysis showed that there has been interest in the NCA across the globe. For example, many African and European nations solicited advice from South Africa to help them with strengthening their credit policies. The NCR also received delegations from Botswana, Namibia, China, Mongolia and the European Coalition for Responsible Credit (ECRC). The NCR's global reach also took it to Brazil where it presented about the NCA at the 3rd Global Credit Reporting Conference.

However, there is paucity in literature regarding the specific provisions of the NCA that the other nations have taken and used in the development, or enhancement of their credit legislation, or what exactly these other countries have learned from the NCA. There is a gap in literature therefore on the impact of the *adopted NCA provisions* in those countries that have taken on board to their credit legislation frameworks some of the NCA provisions.

Based on the international comparative analysis performed, it is recommended that a greater focus be placed on monitoring compliance and collecting and analysing data on consumer complaints. It is also important to assess how these complaints are resolved. This kind of continuous evaluation will be of assistance in shaping future policies regarding the credit market. Regulatory impact assessments including the impact on the users of financial services are an integral component in determining the best possible approaches in attaining a fair, transparent and a developmental credit market.

In conclusion:

- The legislative framework of the NCA will need a review as recommended by a significant amount of research and matters raised by stakeholders as the jurisprudence and declaratory orders have not always led to an optimal solution for the consumer and/or an efficient working of the industry.



- Engagement with the judiciary around clearing the back log is not likely to lead to immediate simple solutions, but is still to be explored as too many consumers remain stuck in a legal debt review process and are not moving towards normalising their debt situation more efficiently as an objective of the NCA.
- A roadmap will have to be drafted for consumers to guide them through the various alternatives in terms of dealing with distressed debt situations, to ensure that a more optimal use is made of the various alternatives available to them.
- The role of all stakeholders in specifically the debt counselling process is to be evaluated and optimised. It is noted in the international research the value of analysing the complaints and resolutions as well as the Ombudsmen should be able to provide valuable insights at this level.
- Developmental credit is a key area requiring further research in the context of defined objectives. Primary research on standardised measurements across a number of years would assist in providing more guidance in this space.
- The objective of the inclusion of juristics in the NCA with limited protections should be further explored and primary research is recommended to measure business practices at credit providers and impact of the inclusion in the NCA on their access to credit.
- Access to credit and the remedies of the NCA will, if left to market forces alone, not benefit the most vulnerable consumers as they are from a revenue point of view, not *attractive consumers* to the commercial credit and debt counselling industry. Supported and funded intervention would be required to enable this access.
- Guidelines around assessing affordability would be required to provide a framework to test against in cases where there is a contention of reckless credit. Whilst not easy to establish norms for expenditure, it is not impossible. One could start by establishing frameworks for completeness, i.e. if financing a car, have insurance and petrol been taking into account from an assessment point of view.
- Standardisation of forms is a key issue, certainly in terms of enabling the consumer to compare quotes, the current practice around providing quotations can benefit from standardisation. Credit life and cost of default should also be clearly reflected on this standardised quotation.
- In the debate around the cost of credit versus the access to credit, care has to be given to manage the intended outcomes. Whilst the general theory of *allowing prices to increase and you will see more credit becoming available* is valid, it does not automatically result in credit providers expanding rural footprint, or moving into previously underserved categories of lending. If concessions to credit providers are to be considered, potentially desired outcomes are to be contracted rather than left to market forces. Given the current highly stressed consumer debt levels, stimulating the credit market into more high risk lending categories may not be advisable at this point. At a different point of the economic cycle, views may differ, but at all points, the decision has to balance in terms of promoting access and curbing indebtedness.

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- We note concerns from credit providers around potential abuse of the remedies of the NCA by consumers and others. However, as consumer protection is critical in a market with low levels of financial literacy – the benefits do outweigh these concerns.



## 2 OUR APPROACH

### 2.1 Introduction

Our general approach to this project is in line with our approach for all projects of a similar nature. We approached this project under the general ambit of our Research Route Map, in which we deployed our other specialised tools such as:

- Literature Review Protocol;
- Project Management Protocol;
- Quality Management Protocol; and
- Report Preparation Protocol.

### 2.2 Literature and document review protocol

Our general literature review framework – known as the **Literature Review Protocol™** – is customised to enable us to conduct a qualitative study of existing literature on the NCA's impact on South Africa's credit market and also on the operations of the NCR. Our Literature Review Protocol™ is as follows:

Table 1: Literature Review Protocol

Protocol	Protocol tenets
Literature Review Protocol™	<ul style="list-style-type: none"> <li>▪ Engage in extensive background reading</li> <li>▪ Define and confirm study</li> <li>▪ Compile keywords</li> <li>▪ Conduct broad strokes interrogation</li> <li>▪ Conduct information mining routine                             <ul style="list-style-type: none"> <li>▪ identify sources</li> <li>▪ locate sources</li> <li>▪ evaluate sources</li> <li>▪ document sources</li> </ul> </li> <li>▪ Compare and contrast views and findings</li> <li>▪ Note gaps in research or views</li> <li>▪ Group experts with similar views</li> <li>▪ Critically analyse views and approaches</li> <li>▪ Apply <i>expert stripping</i> views</li> <li>▪ Note areas of disagreement between experts</li> <li>▪ Highlight exemplary studies</li> <li>▪ Juxtapose expert views with case study results</li> <li>▪ Conduct quality assurance review</li> </ul>

## 3 LEGAL AND COMPLIANCE ASPECTS

### 3.1 Intentions of the NCA

When looking at the legal and compliance impacts of the NCA, the first step should be to look at the intentions of the National Credit Act as outlined in its pre-amble. The intentions are summarised below:

- to promote a fair and non-discriminatory credit process that is transparent;
- to promote black economic empowerment and ownership in the consumer credit industry;
- to promote responsible credit granting and use, and in that context prohibit reckless credit granting;
- to provide for debt re-organisation in case of over-indebtedness;
- to regulate credit information;
- to registrar credit providers, credit bureaus and debt counselling services;
- to promote and advance the social and economic welfare of South Africans;
- to promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry; and
- to protect consumers.

The NCR is established as the appointed regulator who registers the parties and is further responsible for the education, research, policy development, complaints investigations and also ensuring that the Act is indeed enforced. This is not a trivial task considering the above stated objectives.

The Act requires the NCR amongst other things to promote the development of an accessible credit market and particularly to address the needs of:

- historically disadvantaged persons;
- low-income persons;
- remote and isolated communities; and
- low-density communities.

The Act makes specific reference to the NCR's responsibility to set appropriate conditions for the supplementary registration of credit providers wishing to enter into developmental credit agreements in order to promote access to credit. The significant administrative function, coupled with a strategic role in enabling an all-round better functioning credit environment, is highlighted as significant in order to deliver.

A lot of the legal cases that have been published where the Act has been tested on various fronts seem to be focusing on the more narrow issues of interpretation of the process in terms of debt recovery. There is also a high prevalence of the mainstream credit providers in this process arguing their legal points. From a legal perspective, we can look at what hinders the current process particularly in relation to the banking industry, but we seem to be lacking insight of what the impact is and what the legal arguments are from the myriad of other credit providers.

### 3.2 Supreme Court of Appeal of South Africa – 662/2009, 500/2010

At the beginning of their judgement, the Supreme Court began by referencing the intentions of the legislation as well as the international framework around consumer credit legislation, indicating

that their judgment is going to place significant reliance on this. As they state, the NCA cannot be described as the best drafted Act of parliament ever passed. Numerous drafting errors, untidy expressions and inconsistencies make its interpretation a particularly trying exercise. This has led to appeals since everything about the Act is open to interpretation. The court does upfront state that interpretation requires a balance between the competing interest of credit providers and consumers.

The contended legal clauses in the court case are Section 129 and Section 86. Section 129 deals with the credit provider giving notice to the consumer that it will start to enforce the loan agreement. In terms of Section 86, once that process has started, the particular credit agreement will not be part of the debt review process.

When a view is disputed, Section 129 notice says to the consumer (as a compulsory notification) that he may refer the matter to a debt counsellor. The challenge in the interaction between Section 129 and Section 86 is that Section 129 only refers to a single credit agreement, while Section 86 refers to the overall indebtedness situation of the consumer.

The Supreme Court did rule that once Section 129 notice has been issued, that credit agreement will be excluded from the debt review process. So it is not just a notification as the NCR argues, but it is a formal step of enforcement, which will allow the credit provider to start the legal process of enforcement, including the realisation of the collateral they may have. Some door was left open in terms of the fact the courts may still in their discretion refer matters back to a debt counsellor for resolution through the debt review process.

What an order like this does achieve is clarity for the credit providers on process implications but it limits the impact the ongoing uncertainty around this was having on their risk appetite. However, the notification that includes a referral to the debt review process, which basically can no longer be accessed for that specific agreement, is a concept that will confuse consumers. The other matter the Supreme Court ruled on is the common law *in duplum* rule versus the provisions of the NCA in terms of Section 130(5). Simply put, the rule means that the unpaid and arrear interest may not exceed the outstanding capital at any point in time. So at that point, interest stops accruing. In common law, when the debtor starts paying interest down, it may start accruing again. However, the NCA is to be interpreted differently in this ruling, stating that if the legislator intended for the *in duplum* rule to apply as is in common law, it should have stated so. For starters, it does not just pertain to interest and arrear interest but it includes:

- initiation fee;
- service fee;
- credit insurance;
- default administration charges; and
- collection costs.

When the sum of these unpaid charges reaches the level of the principal debt, no more charges or interest may be levied until the default is cured. So, the fact that the consumer may make payments in the interim does not mean charging is resumed (as per common law). The Supreme Court again took guidance from the intentions of the legislation in terms of it promoting responsibility in the credit market by providing for a consistent system of debt restructuring and enforcement.

### 3.3 Further rulings on Section 129

In June 2012 the Sebola case was ruled on before the constitutional court by Cameron J. The essence of the dispute between Mr and Mrs Sebola and Standard Bank was that the Section 129 notice, indicating Standard Bank was going to take legal action in recovering the debt under a home loan agreement, had never been received by the Sebolas. It apparently had been

misrouted in the postal system and hence never reached the intended recipients. The constitutional court ruled that the notice has to be received by the consumer and hence rescinded the default judgment that would have allowed Standard Bank to move to sale in execution of the property. Whilst normally proof of 'registered mail' and proof that the mail was received by the relevant post office is used as proof of delivery, in this case the bank could not prove the latter and the judgment against the Sebolas was hence rescinded.

Three friends of the court were admitted, the Socio-Economic Rights Institute of South Africa, the NCR and the Banking Association of South Africa (BASA). It is clear by these parties' involvement that significant weight is attached to cases like this. So clearly this is a big step in strengthening the rights of the consumer derived from the NCA, as it confirms there is a burden on credit providers to ensure the notice had reached the defaulting consumer before taking any further steps.

For the Credit Provider this does mean additional administrative process to double check 'track and trace' receipts and it may cause delay in the recovery period. Any delay in recovery increases the cost of default to the credit provider further; ultimately all of this will be priced back into the consumer pricing and/or reduce the risk appetite of credit providers further. This was the point being argued strongly by BASA in this case.

The credit providers may have to consider alternate delivery methods given a not always reliable SA postal system. It is noted in a separate judgment by Zondo AJ who agrees to the ruling but relies on common law principles around notice delivery in so far as that delivery has to be to the ultimate consumer not just to the post office given that this Cameron interpretation of the Sebola case would be to the disadvantage of areas where the postal system is insufficient or ineffective.

### **3.4 Debt counselling process – closing the loopholes in the NCA**

As part of the overall review of the debt counselling process which is referred to later in this review again, a number of recommendations around updating the legislation were brought to the table.

- 1 Review of the requirements in terms of qualifications required to register as a debt counsellor by increasing the years of experience required, and adding the requirements of counselling experience as well as the requirement of tertiary qualifications in law, economics or management science.
- 2 Clarify jurisdiction as to whether or not the Magistrate's Court or the High Court has powers in terms of Section 85, if it is alleged in High Court that a consumer is over-indebted. With reference to the Panayiotts case, the suggestion made is to expand the jurisdiction, so that each court presiding over matters relating to a credit agreement and where allegations of over-indebtedness are raised would be empowered to refer the matter to a debt counsellor and deal with the subsequent proceedings around recommendations coming back to the same court in terms of Section 86, or rule on over-indebtedness and issue and order as contemplated in Section 87.
- 3 Introduce a new Form 16 to advise consumers on the consequences of the debt review process.
- 4 Change the regulations and Section 86 (3) to allow for recovery of some of the debt counselling cost from credit providers.
- 5 Amendment of Section 86 (2) to refer to Section 130 instead of Section 129.

This recommendation was made in 2009 and we refer to the discussion above of the Supreme Court ruling on this particular matter as this issue has been the subject of a significant number of legal cases and academic debate. The Supreme Court ruled as it did based on legislation.

The reason why in 2009 this recommendation was made is that, this could well be one of errors in drafting as it is not unrealistic to presume that the legislator intended the reference in Section 86 (2) to be to section 130 rather than Section 129. Section 129 deals with the notice of default to the consumer whilst Section 130 indicates that the credit providers may only approach the court for an order of enforcement on the credit agreement if:

- the consumers is in default for 20 business days or more; and
- at least 10 business days have elapsed since the credit provider delivered a notice to the consumer in terms of Section 86(10) or Section 129(1).

This proposed amendment would hence have ensured the inclusion of defaulted loan agreements if the consumer would apply for debt counselling during the period of the minimum 10 business days – from the day of issuing of the notice up to the day of the formal approach of the credit provider to the court. This would mean the indication on Section 129 notice would be a meaningful referral and this may have been intended to ensure that debt counselling is brought to the consumers' attention at that point.

- 6 Introduction of prescribed forms for the credit providers to submit their certificates of balance by amended in terms of regulation 24(3).
- 7 Amendment of Section 86(6) to include the instance where a recommendation is made by the debt counsellor in terms of Section 86(7)(c) and provide for the obtaining of a consent order when a debt restructuring proposal is accepted by all credit providers.
- 8 Clarity on the procedure to be followed in court when a matter is referred to the Magistrate Court because the consumer and credit providers could not reach consensus on a debt restructuring proposal. Issues around jurisdiction to be addressed.

As per declaratory order 19638/2008, the High Court found that section 86(7) *requires* the debt counsellor, in cases where it has found the consumer to be over-indebted, to seek an order from the Magistrate's Court so as to ensure judicial oversight of the entire process. The implication of the court's decision in this regard is therefore that a debt counsellor is obliged to approach the court for an order in cases of over-indebtedness.

It is the question as to whether or not that was the intention of the recommendation as made in the report. There subsequently has been debate around this as the compulsory referral to court has resulted in challenges in terms of compliance with the various rules of the relevant courts which are not necessarily standardised and the additional work load to the debt counsellor in terms of court appearances, court process requirements etc. The challenge also is the fact that the court process significantly delays finalising agreement around the debt restructure plan for the consumer, resulting in late implementation thereof.

- 9 Amendment of section 86 (7)(c) and Section 87 to provide for the fact that the court could enforce a discharge of part of the consumer's debt obligations.
- 10 Amend Section 14(a) to add Payment Distribution Agents to the parties that the NCR should regulate in addition to credit providers, credit bureaus and debt counsellors and set standards for operation in terms of having sufficient human, financial and operational resources to enable the function as well as relevant and adequate administrative measures and controls to enable an efficient and accurate performance of the function.



- 11 Regulate the process to be followed when a consumer or the debt counsellor withdraws from the process outlining notifications required as well as setting out the implications for the consumer.
- 12 Introduction of a new provision to all the court on application by the consumer may relieve the consumer from disabilities resulting from debt-arrangement, essentially a rehabilitation process.

### 3.5 Interaction between debt relief measures in the NCA and aspects of Insolvency Law

The NCA does not exclude the application of the Insolvency Act, but it significantly influences the insolvency proceedings as the court may in terms of Section 85 of the NCA refer the matter to debt review and thereby invoke the debt relief remedies of the NCA in respect of over-indebtedness. It might be that the direction the court would take it is to not grant a sequestration order but rather refer the consumer for debt review first. A creditor, who is not a credit provider under the NCA, would have their sequestration request thwarted by an intervening credit provider who alleges debt restructuring to be a better option. Clearly, a credit provider arguing for sequestration is going to have to convince the court that there are sufficient grounds to support that route other than to go through a debt re-arrangement.

In case of voluntary surrender, applicant-debtors will definitely have to consider their options outside of sequestration, especially looking to the debt relief procedures provided for in the NCA. This approach was evident in the High Court case (Western Cape) Ex Parte Ford 921084/8) where the court indicated that a considerable portion of each of their respective liabilities consisted of debt owed to financial institutions or money lenders, either by way of loans on overdraft or otherwise, or as a consequence of the extension of credit through credit card facilities. On the face of it therefore, it appeared that the major portion of each of the applicant's debt arose out of *credit agreements* within the meaning of the NCA. It was also striking on paper how disproportionately high the amount of this type of debt was in each case in relation to the relatively modest incomes of the applicants. However, the court did not rule or order onto referral to the NCA remedies but it left that option open to the applicants.

The following extract of the ruling is noted: ... it is the duty of the court, in the exercise of its discretion in cases like the current, to have proper regard to giving due effect to the public policy reflected in the NCA. That public policy gives preference to rights of responsible credit grantors over reckless credit grantors and enjoys full satisfaction as far as possible by the consumer, of all *responsible financial obligations*.

The NCA appears to have changed the approach and certainly any consumer who wishes to apply for voluntary sequestration should explore debt review and make sure the debt counsellor does investigate the possibility of reckless credit. A credit provider choosing this route might save himself unnecessary cost and delay if debt review has been closed out. However, it is not a one size fits all and courts should exercise discretion in this regard. The rights of all creditors and not just the credit providers would have to be weighed in a ruling on a request for sequestration.

A further alignment or convergence of the NCA and Insolvency legislation should be considered in light of the fact that ultimately, the NCA remedies are limiting in the sense that they can only restructure debt. Whilst Insolvency law is seen to benefit the creditors only, it does put the ultimate stop to the debt situation by providing a debt discharge and full financial rehabilitation (within timeframes).

A more holistic approach, taking into consideration all creditors and not just the credit providers, working towards the full spectrum of debt relief mechanisms available, would be beneficial to the consumer – remediates conflicts of interest between creditors in general and credit providers in terms of the NCA as well as provide clarity of process.

Later, academic debate starts separating the voluntary surrender from compulsory sequestration. Whilst the court was very pro-active in challenging the request for voluntary surrender in light of what seemingly was reckless credit, it could not have intended for debt review to become a compulsory step before applying for voluntary surrender. The debtor however should consider whether his situation cannot be dealt with more effectively and to the advantage of the creditor by using the remedies available in terms of the NCA. If they decide not to, courts will still have the ability to postpone their applications and refer the matter in terms of Section 85 (a) of the NCA. In terms of the compulsory sequestration, it is held in the debate that the court could not refer to the debt review process as the applicant is now the credit provider and they are not in a position to force the consumer into debt review. It is the consumer that chooses to pursue that route. The Mutemeri case (Investec Bank Ltd and Another v Mutemeri and Another 2010 (1) SA 265 (GSJ)) ruling indicates that the application for compulsory sequestration is not a civil procedure in terms of debt enforcement with regard to the NCA and therefore is not subject to its provisions. So, the estate of a consumer under debt review may well be sequestrated. The rationale being that debt review only reschedules debt and leaves the consumer with a longer period to pay the debt – increasing the total amount to be repaid by extending the period – which many not serve the purpose of an insolvent debtor, who simply lacks the ability to repay at all, even over a much longer timeframe.

So what is the conclusion to the above debate? It acknowledges the importance of the NCA remedies and certainly indicates that consumers should pursue these ahead of other mechanisms like, applying for voluntary surrender. The courts may point or order the consumer in this direction. It is certainly the provisions around reckless credit that play a role in the court's mind and so if not pursued, it prejudices the other (non-reckless) creditors. However, it is also noted that debt review is not always an option. One can only reschedule debt if there is an adequate income stream to service it, be it over a longer period or short period of time. Sequestration hence can be pursued by creditors including credit providers as an option – either because there is no reasonable restructuring plan viable, or, the restructuring plan has already failed due to non-payment, or, was simply not complete. Therefore, a referral back as a matter of course in any insolvency application would be incorrect and should only be pursued if there is a reasonable chance it would actually be advantageous and not constitute a delay of the inevitable at the expense of further growing the consumers' debts.

### **3.6 Rights of surety under the NCA – Desert Star Trading v No 11 Flamboyant Edleen (98/10)**

One of the lesser debated points is the credit guarantee, or more commonly known as the suretyship which is routinely used by credit providers and specifically banks to have recourse to others than just the borrower in case of default.

The suretyship is an accessory to the main credit agreement also called the principal debt. The surety hence can only raise a defence in terms of the NCA, if the NCA applies to the main credit agreement. The Supreme Court of Appeal in Desert Star Trading took the view that a suretyship falls within the definition of a credit guarantee in terms of Section 8(5) of the NCA. The definition there is that, a credit guarantee exists when a person undertakes or promises to satisfy upon demand any obligation of another consumer in terms of credit facility, or a credit transaction to which this Act applies.

This is a significant right since now the surety will be in a position to raise any defence the principal debtor has raised, or could raise a defence of their own based on his/her personal circumstance. In the case at hand the argument of reckless lending by a student and an



unemployed housewife, whose lack of affordability is evident and clearly indicates no assessment was done.

This means that the practise which is often used to get spouses to sign surety even if they do not have an income of their own may lose value. This has implications where sureties are used to tie collateral to a particular loan in cases where one spouse has the income and hence is the borrower from an affordability point of view, but the asset used for collateral e.g. the house, is owned by the other unemployed spouse. This implies that the credit provider can lose access to its collateral because the suretyship could be set aside as reckless.

### 3.7 Reckless credit concept

Reckless credit is a concept that is new to the South African legal system, introduced by the NCA. The introduction of reckless credit means a significantly higher burden on the affordability checks at the point of granting credit – something that has been pointed out as subduing the credit market. The new parameters should however ensure that the consumers will not become so easily over-indebted. In a deteriorating economy, affordability checks are key and whilst it will be costly to credit providers and may well lead to a decline in the number of approvals, it is the level of bad debt write offs and personal indebtedness that are influenced in a positive way.

Over-indebtedness is another legal concept introduced by the NCA – which means that a court can make an order declaring a consumer over-indebted. This means that he/she cannot satisfy all obligations under the credit agreements entered into considering financial means, prospects and other obligations. How exactly this determination is being done is open to some interpretation based on the wording used. Internationally, referencing these definitions renders a more straight forward definition like the one used in Austria by a debt counselling agency, IFS Schuldnerberatung, which indicates that *consumers are over-indebted if after deduction of current cost of living like food, clothes, rent, social and cultural needs/requirements, they are not able to discharge all payment obligations*. External benchmarks, like the income and expenditure data produced by Statistics South Africa may be useful in this context.

Reckless credit does not apply to juristics but it only applies to natural persons. Furthermore, school and student loans, emergency loans, public interest credit agreements, incidental credit agreements and temporary increases are not subject to these provisions. These loans have to be reported in the prescribed manner and form.

The exclusion only applies to the reckless lending provisions and not to over-indebtedness. This would probably explain why banks have taken the *rather safe than sorry approach* and now give student loans to parents for their kids, rather than financing the student themselves.

The credit provider must take all reasonable steps to ensure that they properly assess the consumer. However, if the client withholds information or gives incorrect details, this can be used as an adequate defence. Assessment of repayment history as well as existing means prospects and obligations are also crucial. If the dependency for repayment is on a new venture, feasibility studies may be required. This assessment has to happen before any further lending takes place.

In terms of over-indebtedness, we have two forms being highlighted. One is general over-indebtedness, *which occurs usually through a chance in circumstances, after the consumer has entered into the credit agreement*. Reckless over-indebtedness is *where the mere entering into the agreement is putting the consumer into a situation of over-indebtedness, i.e. the lending was reckless*. The sanction for the credit providers is grave as the court may make an order setting aside all or part of the rights and obligations under the agreement, or may suspend the force and effect of the credit agreement until a later date (determined by the court). It is important to note that reckless lending can only be argued by a consumer if via the debt counsellor, it has been established the consumer is indeed over-indebted.

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### 3.7.1 Reckless lending findings

#### Absa – PE Magistrates Court:

Absa was found reckless in March 2010 in providing a loan to a pensioner of 81 years old who only had an income of R3700 and the repayments were R4200. The loan was given after a number of other credit providers had already turned the consumer down. The argument used was that the funds were meant for the daughter's business and she stood surety for the loan and that was taken into consideration in terms of the affordability assessment. The business did not take off and the pensioner was about to lose his house. The Port Elizabeth Magistrates Court ruled it reckless lending and set aside the loan agreement.

### 3.7.2 Standard Bank of South Africa Ltd v Kelly and another (23427/2010) [2011]

In this judgment, the court rejected the after-the-fact allegation by a debtor that he was not properly appraised of the risks of the credit agreement because he signed the bank's standard document in which he acknowledged his understanding of the risks. The matter is otherwise noteworthy because the court explains what information a debtor must place before a court before it can make a finding on whether a credit agreement constitutes reckless lending or not, by placing on burden of proof on them to indicate:

- why they would view the information they provide as inadequate to make an informed credit decision;
- on which basis they now argue that the standard declaration they signed was not understood at the time;
- why they signed an acknowledgement that they understood the risks and cost of the loan; and
- the grounds for debt review required as debt review (indebtedness) is a pre-requisite for any claim of reckless lending

### 3.7.3 Reckless lending rulings by the Banking Ombud

The complainant was the beneficiary of a trust fund, which paid out a large sum to a consumer monthly. She had a home loan with the bank which was fully settled in 2000. In 2010, she applied for a further loan to be secured by her property, which was registered in the name of the trust. In spite of the trustees' lack of consent to the registration of a bond over the property, the bank granted the loan. The trustees decided to limit the amount paid out to the complainant due to her spending habits. The complainant was then unable to repay the loan to the bank. She then alleged that the bank was reckless in granting her the loan and asked that the amount be written off.

An investigation found no evidence of reckless lending. Banks are entitled to rely on the information provided to them by the applicant regarding his or her income and expenditure, but are expected to do reasonable checks to confirm the financial background of the customer – such as credit bureaus checks. The bank cannot be held liable for reckless lending if the complainant has not submitted relevant information or had misled the bank about his/her income and expenditure. The complainant's trust income combined with her employment income was substantial and there was no evidence to show that the bank was aware or should have been aware of problems between her and the trust regarding her spending. The Banking Ombud hence for the above mentioned reason rejected the complaint finding in favour of the bank.

In another matter, the Banking Ombud did find in favour of a consumer who managed to rack up a higher balance on her credit card than the limit that was set for her. The reason she managed to exceed her limit was investigated and it was revealed that there was a time delay between the account withdrawals and the amounts credited by the vendor. The actual balance would reflect only once the credit and debit transactions submitted by the vendor had been reconciled. The bank conceded that a system error allowed the complainant to exceed her credit limit significantly. She had continued gambling without verifying the amounts she was betting against the amounts she was winning. In reality, she had lost far more than she had won. The Bank agreed to write off the amount that she exceeded her limit by which was over R150 000. Her limit was only R15 000.

There are a few reckless lending findings on record and seemingly whilst at the time of publication innocence is protested by the credit provider, they generally do not take these on appeal. One would presume that they would also consider the consumer in question and whilst there may be a legal principle to be explored, it would create a lot of bad publicity if that is done on the back of the consumers in question.

We note later in this review that there has been a reluctance of debt counsellors to pursue this route given that it is seen as rather fruitless and damaging to the relationship with the credit provider. Similarly, a lot of claims, as also noted by the Banking Ombud, are baseless because consumers have mostly become over-indebted subsequent to the granting of the loan.

### 3.8 The legal system overall

Various sources point to a bottle neck in the court system in handling the cases around debt review and restructure. Statistics quoted differ but they all point to a very similar problem. A very small percentage, less than 10%, is actually being processed by the courts in relation to the amount of cases lodged. This clearly completely contradicts the objective of the NCA, which is to provide alternate solutions for consumers to deal with their debt situation in an expedient manner by re-arranging and normalising their debt situation to a manageable level. It is therefore logical that recommendations are being made that the NCR should seek engagement with the Department of Justice and engage around crafting a way forward that would deal with the large backlog and that would assist in providing alternative routes especially for non-contested cases – which should be dealt with on a more administrative basis even if the courts are still the conduit for sign off.

The various rulings and declaratory orders have assisted in clarifying the process and taking some of the uncertainty out of the process. However, one cannot be sure if the outcome of the court orders matches the intentions of the legislator, who unfortunately left many matters open to interpretation. Courts have tried and this is evidenced by their arguments to be guided by the principles of the NCA, but by the same token, they are limited by legislation to a degree as they seek to interpret and not radically change the legislation. Hence, consumers certainly do not come out as the *winning party* in a large number of the cases.

## 4 INSTITUTIONAL IMPACT

### 4.1 Credit providers

The credit process for the credit providers has changed fundamentally with the advent of the NCA. In the lead up to the implementation of the NCA, a lot of work was done by the credit providers to ensure compliance when the Act came into effect. The large banks in South Africa spent millions of rands in implementation cost. In spite of the expenditure and the activity, fairly few credit providers were ready with their implementation projects by the 1st of June 2007. At the outset, credit approval turnaround times were slowing down significantly leading to complaints from consumers but also from the bond originators and real estate agents who had real interests in quick turnaround property transactions.

The subsequent subprime crisis that hit the world economy in 2008 had its repercussions for the credit industry. It is also a distorting factor for any research in terms of the real impact of the NCA because the years before the crisis and just after the implementation of NCA, as well as the couple of years that followed are very difficult to compare and distinguish the impact of the NCA from the impact of the crisis itself. Clearly, even without the NCA, given a fall out in terms of increasing non-payment by consumers due to loss of jobs and other economic factors, as well as the reduction in value of the collateral provided by consumers and resultant bad debt write offs on the part of credit providers who could no longer sell houses and/or cars at a market related prices to recover the consumers' debts, we would have seen a much more conservative credit granting policy after this. Credit providers did pay the price in bad debts for the flurry of credit activity that proceeded the 1st of June implementation date of the NCA. General consensus from various sources seem to be that the NCA is to be credited for having had a positive impact in terms of improving the quality of the credit decisions and hence limiting the impact of the credit crisis on the South African consumer and economy.

*So what were the impacts on the credit providers?*

#### 4.1.1 Cost of compliance

Cost of compliance was increased in the:

- credit granting process, given the demand for an increasingly robust assessment process, which also requires the completion and retention of information use;
- legal cost as quotes and pre-agreements were introduced and agreements re-written to comply with the NCA;
- legal cost of familiarising oneself with the implications of a new piece of legislation including the pursuit of *test cases*;
- debt counselling function, which previously did not exist as such within the credit providers' organisations;
- industry engagement around the implementation and workings of the Act; and
- staff skills and training requirements.

#### 4.1.2 Reduction in revenue

- Stricter credit assessment criteria led to a lowering of the rate of approval.
- Fee caps were imposed on credit products where the maximum fee of an unsecured loan is now R1000 + VAT, and for a mortgage loan it is R5000 +VAT.

- Whilst previously the Usury Act set limitations on the maximum interest that could be charged, micro lending was mostly exempt from those controls and hence *unlimited* amounts of interest were charged in this space.

### 4.1.3 Risk reduction

- Stricter credit assessment criteria resulting in a lesser amount of consumers not being able to repay their debt, ultimately resulting in bad debt write off cost for the credit provider.
- More extensive credit bureau information giving the credit providers more insight in the consumers total debt situation.
- Debt counselling to provide quicker resolution around non-payment thereby limiting recovery cost and work towards (partial) repayment of outstanding debt.

Researchers have been trying to establish the impact of these counterbalancing forces in terms of impact. There seems to be no clear formula that weighs the various impacts and determines which one would be the dominant factor. The impact is further influenced by the type of credit provider as e.g. the interest rate restrictions on micro loans lead to decreasing revenue at the micro lenders, it created a positive revenue implication on the side of the banking industry, where we note an expansion of the unsecured lending space. When one considers the valuation of a bank as a company, one would find the impact of the credit granting elements both in lowering growth rates for modelling purposes as well as lowering Beta, which is the indicator around the systemic risk present in the bank as it becomes less susceptible via the retail loan book (loans to individuals) to the general movement in the market place. Exploratory research indicates that the impact of earnings is higher than the impact of the Beta on the valuation of Banks, i.e. a net negative result. As the research is only exploratory and not supported (yet) by a bigger body of knowledge, we will refrain from drawing conclusions around this point.

## 4.2 NDMA – National Debt Mediation Association

One of the new organisations that emerged as a result of the NCA was the NDMA, which currently has 34 credit providers affiliated to it. It covers about 90% over the overall credit provision in the market to individuals. The industry task team recommendations and a newly negotiated credit industry code of conduct established a mandate for the NDMA as the body through which the credit industry will coordinate and execute its obligations. The code is the practical implementation of provisions of the National Credit Act which in section 48(1)(b) puts an obligation on credit providers to manage and prevent over-indebtedness. The NDMA is attempting to achieve a consensual debt resolution between debt counsellors, consumers and credit providers.

The NDMA is not a regulatory body but aims to facilitate debt mediation by setting up rules and standards for this process. It also deals with complaints around credit providers and their conduct in the debt counselling process. It further aims to credit awareness and get consumers to engage with their credit providers before it even gets to the point of debt counselling to explore multiple options for resolution.

So essentially it is a:

- collaboration of credit providers to facilitate engagements with all other stakeholders in this industry as well as co-ordination body for implementation of rules, standards and processes;



- complaints' centre that provides information and can through mediation resolve complaints with their members, or refer to statutory bodies like the NCR, the NCT and the Credit Ombud; and
- governing body that monitors compliance to the credit code of conduct.

The NDMA was clearly formed in reaction to the implementation of the NCA. Whilst the general debt problem in the country may have given rise to joint initiatives by credit providers around facilitating a form of debt review, it certainly would not have had the impetus it had if it were not for the introduction of the debt counselling process via the NCA.

Credit providers have not been silent about the impact the debt counselling process has had on delaying their debt recovery process. Hence, it is not surprising that they formed the NDMA as an alternative debt resolution agent.

In all its communication, it clearly promotes the agenda of supporting the objectives of the NCA. Self-regulation by the industry and the ability of the NDMA in terms of its link to the credit providers to get these stakeholders to reconsider cases, re-instate terminated debt reviews and generally provide input in a process that sometimes does get stuck in bureaucracy – fragmented approaches of particularly large credit providers is extremely valuable.

## 4.3 Credit bureaus

The credit bureaus increases in relevance within the industry as their role is embedded in the NCA structures.

One of the tasks given to them is to enable and expand engagement with the consumers where they now have the right to view their credit record and interrogate/question any information reflected. The Act regulates that once a year, a consumer can view their credit record without any cost.

In terms of disputes of information at the Credit Bureaus, the Credit Ombud reveals the following statistics:

**Table 2: Disputes of information at Credit Bureaus**

Year	Total disputes	Monthly Average Disputes	Resolution ratio
2010	52 203	4350	93.6%
2009	52 188	4349	97.1%
2008	53 964	4497	97.3%
2007	119 000	9917	98.6%
2006	41 947	3498	96.8%

At the inception of the NCA, a lot of awareness was created around the necessity to check and validate bureau information by consumers as the engagement almost tripled from the previous year. The consumer would have also wanted to verify that his credit record had been updated in line with the changes that the NCA brought about. It was Section 73 of the NCA that made provision for the removal of:

- default data below R500;
- judgments less than R5 000 if incurred before September 2006;
- judgments below R50 000 if settled before September 2006;
- dormant accounts if older than 2 years by September 2006; and
- judgments below R50 000 taken before September 2006 and settled before September 2007 (consumer to provide proof of payment).

The fact that the Credit Ombud spent R5 million on advertising to inform consumers of their rights undoubtedly greatly influenced the number of queries lodged. This campaign was sponsored by:

- the NCR;
- the big 4 banks; and
- African Bank Ltd.

From 2008, the disputes stabilised at a level of about 125% of its pre NCA level. So awareness creation has had a lasting effect in increasing engagement with the credit bureaus. 2006 was already up by 68% from 2005, due to the implementation of the National Credit Act's Credit Bureau regulations in September 2006. This was helped by the growing awareness around the role of the Credit Information Ombud since 2010, referred to as the Credit Ombud.

Internal evaluation of the NCR highlights the engagement with the credit bureaus by the NCR as positive. There was a minimal amount of negative media reporting around the interaction between the NCR and the credit bureaus.

As with most key stakeholders that have a direct dependency on the NCA, we see no real push back in the media or elsewhere in terms of the objectives of the NCA and the relationship with the NCR. Clearly, the good relationship with the NCR is key to their businesses, and it would not be in their interest to enter into public debate.

The Credit bureaus' environment has changed. The free access to the credit information by the consumer as well as their ability to dispute data has changed the way business is done, and has given credit bureaus a clearer consumer face. It is however pointed out in some of the media reports that as far as the bureaus are concerned, it is the credit provider that pays for access to that information.

### **4.3.1 Data privacy legislation impacting credit bureaus**

New data privacy legislation is about to be introduced within the South African environment and hence we explore the background behind this. At this point, is it not clear to what extent this will change the credit bureaus environment as well as the consumer position since the NCA already provides very specific guidelines. Potentially, the level of consent required from consumers may change.

It is accepted that credit bureaus facilitate the sharing of information between credit providers and achieve a number of objectives. Quite importantly, it solves for the information monopoly, making the consumers bargaining power in the market that much more efficient as his/her credit record is known. It should also reduce over-indebtedness. Information sharing between lenders reveals borrowers' debt exposure to all participating lenders – eventually reducing aggregate indebtedness as highly indebted individuals receive less credit.

The OECD conducted research and came up with following recommendations, also in light of the data privacy impact.



- Private credit registries tend to surpass public credit registries in the comprehensiveness of the data and services they provide to lenders. However, public credit registries can be an effective tool to improve the amount and quality of information available on borrowers in emerging economies with non-existent or under-developed information sharing institutions.
- Data protection and the right to privacy are fundamental to the establishment of a private credit bureau. Governments should ensure that a legal framework is in place that protects privacy but does not stifle the creation of private credit bureaus. In particular, international standards, such as the *OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data* should be enshrined in legislation, and cost benefit analyses should be conducted to determine whether the marginal benefit of particular privacy restrictions outweighs any marginal loss in efficiency.
- Countries which have less efficient and more time consuming judicial procedures should establish a powerful regulatory authority to enforce data protection legislation and monitor information-sharing institutions. The authority should be provided with the appropriate enforcement tools, the ability to collect information and investigate wrong-doing, and resources to publicise consumer rights. The authority should also be held accountable to the public.
- Before putting in place any regulation or institutions associated with information sharing, governments are encouraged to elicit comments and expertise not only from their own domestic private sector, but also from large international private credit bureaus. Many of these firms have years of experience in dealing with legal and regulatory environments surrounding information sharing, and can provide particularly useful information on potential obstacles or unintended consequences that new laws can pose to sharing information.

In that light, we note that consideration of the requirement relating to credit bureaus credit bureaus as well as the OECD guidelines did occur in our jurisdiction as evidenced by the discussion paper of 2005 of the Law Reform Commission before introducing Privacy Protection legislation.

The South African Protection of Personal Information Bill 009 of 2009(POPI) once enacted aims to:

- promote the protection of personal information processed by public and private bodies;
- introduce information protection principles so as to establish minimum requirements for the processing of personal information;
- provide for the establishment of an Information Protection Regulator;
- provide for the issuing of codes of conduct;
- provide for the rights of persons regarding unsolicited electronic communications and automated decision making;
- regulate the flow of personal information across the borders of the republic; and
- provide for matters connected therewith.

It is noted that in the interim that the NCA measures means the records of consumer credit information kept by the credit bureaus must be maintained in accordance with the following standards:

- identified by the consumer's identity number or passport number, or where no identity number or passport number is available for a particular person, any other reasonable method to identify the record;
- collected, processed and distributed in a manner that ensures that the records remain confidential and secure;

- protected against accidental, unlawful destruction and unlawful intrusion;
- protected against loss or wrongful alteration;
- protected against unauthorised disclosure or access by any unauthorised person; and
- the credit bureau must take all reasonable steps to ensure that all records are kept up to date.

These standards are in accordance with the objectives of the new POPI Act.

To what extent POPI is going to change the rules around the credit bureaus remains to be seen. It is likely to increase the compliance burden on the side of credit providers and credit bureaus to ensure that information is correct and appropriately utilised.

Unfortunately, based on experience, it is very difficult for any business to fully prepare in advance for new legislation as the final version invariably has a number of differences from the various versions of the Bills that are created in the consultative process, which in themselves often have fundamental changes between them. It does seem as though there will be a grace period of a year to fully comply with the regulations.

It may impact the level of consent required from the consumer around sharing and obtaining the information. Currently, consumer consent is obtained, but withholding consent by the consumer would mean an implicit decline of the finance request.

## 4.4 Debt counsellors

Debt counsellors are a completely new phenomenon in the credit industry. They did not upfront shape the way the NCA was going to look, but they certainly significantly influence the manner in which the NCA is shaping the credit industry and the consumer experience. The role of the debt counsellor is to assist the client with the debt review process as prescribed in Section 86 of the Act. There is a minimum requirement for a debt counsellor to at least have a Matric qualification, pass the 5 day debt counselling course, and additionally have 2 years' experience in any of the following fields:

- consumer protection;
- complaints resolution or consumer advisory service;
- legal or paralegal services;
- accounting or financial services;
- education or training of individuals;
- counselling of individuals; and
- general business environment.

Furthermore, the person must have demonstrated the ability to manage their own finances and be registered with SARS as a taxpayer.

The experience requirements are widely defined and actual qualifications required are quite limited. There has been quite a significant amount of voluntary de-registrations that took place of debt counsellors that initially went into this new profession. One of the main reasons for this has been the complexity of the legislation and the legislative process, which are difficult to manage when the debt counsellor lacks the legal background and does not have access to in-house legal counsel in the firm he/she is associated with. The demand on legal knowledge stems from the fact that rather than being a voluntary negotiated process, conclusion of an agreement requires one or more court appearances.

Since the declaratory order of 2009, which the NCR requested from the High Court, the burden on debt counsellors in this respect increased as all applications for debt review have to be

submitted to the Magistrates Court, irrespective of whether or not credit providers have consented:

- increased burden to provide supporting documentation;
- debt counsellor is the applicant (consumer is first respondent and credit providers second, third etc.);
- matters must be heard where the consumer resides and not at the debt counsellor's business area;
- paperwork is to be served on respondents as per the normal court process; and
- debt counsellors are required to be present at the hearing.

The original challenge involved in managing legal processes and handling the complications that occur during the *aftercare stage* of the debt review where, the debt counsellor manages engagements with PDAs and credit providers on an ongoing basis were much more than originally anticipated and require a deeper level of understanding as well as continued involvement. This gives way to debate around the fee structures which were originally agreed and eventually did lead to some increases being applied based on the NCR commission research.

Debt counsellors have been significantly criticised. One of the issues raised has been around collusion with consumers. An example is the controversy with regards to the taxi industry where debt counsellors were seen to actively recruit taxi owners into the debt counselling process – the carrot being the 60 day lock down period (meant to do an inventory on debts outstanding and coming up with a proposal for restructuring) which was being touted as a payment holiday. Subsequent court rulings which now indicated the repossession of vehicles can proceed in the interim, has ensured that this practice is no longer attractive to consumers seeking a bit of relief from their creditors (whilst not really being over-indebted).

#### 4.4.1 The Debt Counsellors Association of South Africa (DCASA)

Debt counsellors have organised themselves into an association similar to the credit providers that participates in the discussion of matters of interest on debt counselling with:

- the NCR;
- credit providers; and
- credit bureaus.

It advises the NCR of all discriminatory practices relating to the reckless granting of credit to consumers and protects consumers against prejudicial and/or unlawful and/or discriminatory practice by credit providers and/or their agents and/or other debt counsellors. It takes any measures which may be considered desirable to further the interest of its members and is a centre of excellence and provider of courses and training to empower them as appropriate debt counsellors.

From their communications, it is clear that DCASA values the relationship it has with the NCR and in the early stages applauds the NCR for the support it is providing in establishing this new industry and enabling training interventions. The NCR also created the place for dialogue between debt counsellors and credit providers. Credit providers provided debt counsellors with significant challenges, not necessarily at industry engagement level, but in the space where the practical implementation happens. We will expand on that in further detail later.

DCASA is playing an active role, and in 2011 it submitted a proposal for changes for the NCA to Minister Rob Davies and **the dti** – the proposal has recently been further worked on and is now more detailed. The main issues raised are around the terminations of debt review, Section 129,

the court process and the training of debt counsellors. These matters are flagged as critical and to be addressed.

As per DCASA, the request to address terminations is based on the fact that many credit providers have used the Collette Judgment to issue bulk terminations without giving the debt counsellor a fair chance to submit reasonable proposals. (The Appeal Court made two important findings in the Collette judgement. The first is that a credit provider is entitled to terminate after 60 days has expired but the Judgment makes it clear that a credit provider's failure to participate in good faith may be a basis of a request to a court not to grant Summary Judgement and to refer the agreement back to the debt counsellor. DCASA feels this has led to more bulk terminations without due consideration.)

Furthermore, they feel that in light of Section 129 Judgments, many credit providers use this method to exclude asset based credit agreements from the debt review. The need to reintroduce the original intention with Section 129 notices should be one of the changes to the NCA.

DCASA indicates the current court process has many difficulties. It is based on Rule 55 but every magistrate has a different view of the requirements and processes. This makes preparation for applications by debt counselors almost impossible. Furthermore, the debt counsellors receive poor services from attorneys hence; strongly advocate a standard court process.

DCASA furthermore does sponsor certain appeals in terms of court cases to ensure that clarity is obtained on matters relevant to the debt counselling process.

## 4.5 Employers

It is DCASA that highlights another role player in the overall process and that is the employer. They note an increase in engagement from the employers of staff in financial difficulty since the implementation of the NCA.

It goes without saying that there is a correlation between the level of financial worries of an employee and his productivity – as they spend working time trying to handle the consequences of their financial predicaments. Financial worries lead to absenteeism, employees absconding from work and even theft. The cost of managing financial affairs for employees in terms of administering salary deductions and garnishee orders puts a burden on the business.

Additionally, one might see employees resign in order to access their retirement funds to settle their debt burden. As a result, the consumer ultimately ends up retiring without having any significant provisions in place.

Employers have realised the above and play a role in providing assistance, which they are doing on an increasing basis by:

- providing financial wellbeing programmes to assist employees to understand and manage their personal finances;
- actively encouraging employees to improve personal financial education by using the above programmes;
- engaging with unions for support to improve personal financial skills;
- actively removing easily accessed loan schemes from the workplace;
- implementing compulsory financial literacy training for employees; and
- identification and referral of debt stressed employees to debt counsellors.

This is an encouraging development as legislation has an important role to play. But where private sector starts understanding the relevance of the overarching principles behind such

legislation and acts on this, it helps to building a more holistic solution across society towards achieving the objectives of such legislation.

## 4.6 Payment Distribution Agencies

Debt counsellors are not allowed to collect and distribute payments to credit providers once the consumers' debt position has been restructured. This is the ambit of the Payment Distribution Agencies. They are a key part of the overall process, but the only stakeholder that is not formally regulated by the NCR. The NCR has however accredited Payment Distribution Agencies who are responsible for collecting repayments from consumers and distributing this in line with the restructured agreements to credit providers.

The Payment Distribution Agencies have been plagued by administrative challenges. A number of these challenges emanated from challenges in the preceding process where the debt counsellor collects information from the credit providers. This includes, errors in recording the correct numbers, either just because of data capture errors when transposing details or because certificates of balance issued by the credit providers were either incorrect or illegible.

Further challenges were identified in the payment process where consumers make payment and these are not allocated correctly, possibly because of insufficient information. Furthermore, technical issues with the software at the PDAs also brought challenges into the process. A lack of validation of underlying details, different account number structures from various providers etc. further complicates smooth executions. The PDAs are very dependent on debt counsellors providing 100% correct data on the agreements for execution.

Furthermore, once executed, the consumer and debt counsellor are reliant on the PDA to provide proof of payment on demand and with quick turnaround times. Not being able to trace payments once made can have disastrous consequences for consumers who now still risk losing their property if they cannot provide proof that they are adhering to the arrangements made.

Given the key role these agencies play in the process, it is not surprising that recommendations have been made to include the PDAs in the scope of the regulations and under the regulatory oversight of the NCR.

Whilst there is a code of conduct in place and engagement is happening, from a regulatory point of view, the PDAs should be held up to the exact same standard. Doing that would also enable inclusion of the PDAs into the scope of the Credit Ombud.

Not widely debated, but noted for completeness is the fact that the increasing level of debt review cases does result in significant increases in the funds held by the Payment Distribution Agencies. Whilst there is no indication of any mismanagement, it would be prudent for oversight to be established on the management of funds by these payment utilities. The financial stability of these agencies is essential to a functional debt restructure process. Failure of such agencies would have serious implications for consumers and on the confidence in the debt restructure process.

The PDAs are associated via the Payment Distribution Association of South Africa.

## 4.7 Codes of conduct

The codes of conduct that have drafted and accepted by the credit providers, debt counsellors and Payment Distribution Agencies for their respective roles, are evidencing the engagement that is in place and shows the detail that industry has gone into to clarify the framework around the managing the NCA. These codes are the result of the debt review task team that was set up in response to the 2009 research done into the debt counselling process.



Evaluation is yet to be done regarding the impact of the codes of conduct on future challenges that the industry may face, but it certainly has established a good point of departure. More important than just the code, is the engagement that underpins the establishment of such a code.

There are 3 codes of conduct in place:

- Credit industry code of conduct to combat over-indebtedness in terms of S 48 (1) (b) of the National Credit Act (NCA);
- Debt counsellor's code of conduct; and
- Payment Distribution Agents (PDAs) code of conduct.

#### **4.7.1 Credit industry code of conduct to combat over-indebtedness**

Under the new (January 2011) *Credit Industry code of conduct to combat over-indebtedness* in terms of S 48 (1) (b) of the National Credit Act (NCA), the credit industry has made the following commitments:

- To lend responsibly and avoid over-indebtedness from occurring where possible.
- To comply with any voluntary industry agreed processes, timeframes, rules and procedures for receiving and responding to debt counselling applications.
- To comply with the legal and procedural requirements for statutory debt counselling in terms of the National Credit Act and all other relevant legislation.
- To implement effective policies and procedures for dealing with the cancellation of existing debit orders, payroll deduction arrangements and stop orders on the duly authorised instruction of the consumer.
- To diligently implement all the terms and consequential payment arrangements of any debt restructuring agreements to relieve over indebtedness reached in the statutory debt counselling process.
- Not to terminate debt review proceedings or resort to litigation in respect of the affected credit agreement whilst a consumer has lodged a complaint with the NDMA or has declared a dispute and it is being dealt with by the Credit Ombud.
- To comply with any guidelines issued by the National Credit Regulator and adopted in terms of the code relating to how credit providers will conduct themselves or manage the debt counselling process.

#### **4.7.2 The debt counsellor's code of conduct**

- To adopt voluntary process and agreements in order to facilitate a more efficient debt review process.
- To adhere to agreed levels of professionalism.
- To market the services of debt counselling correctly and responsibly and ensure consumers understand the implications of debt review via explanations in plain and clear language.



- To accept for debt review and assist consumers who can set up a restructure plan, and decline those for whom that is not possible.
- To work only with registered counterparts from PDA perspective.
- To subscribe to the necessary industry bodies and refer and adhere to the appropriate complaints resolution channels like the Credit Ombud.
- To have professional indemnity insurance in place.
- To adopt further forms, standardisation of restructure rules in setting up payment plans and dispute resolution avenues as agreed with the task team that was established by the NCR.
- To adhere to any further rules that may be established by the National Debt Review committee once in office.
- To provide consumer education.
- To adhere to the necessary governance around dispute resolution, monitoring and evaluation and reporting.

### **4.7.3 The Payment Distribution Association's code of conduct**

The last code of conduct is a mirror image of the debt counselling code of conduct with specific differences relating to their particular function.

We do note that in the code of conduct, they specifically agree to accreditation by the NCR, which whilst they do not regulate this part of the industry, it does give comfort to see a level of oversight being arranged voluntarily.

Their specific business commitments in the code are:

- As far as possible, implement payment instructions that conform to debt rearrangement rules as proposed by the NDRC and that are approved by the NCR from time to time.
- From time to time, conduct a review of payment plans submitted by debt counsellors and check whether these conform to the debt re-arrangement rules.
- Where a debt counsellor habitually submits plans that appear not to conform to the debt re-arrangement rules, report that debt counsellor to DCASA, or other recognised industry body, as applicable.
- Support PDASA as a member of the NDRC in overseeing the effective implementation and ongoing monitoring and review of such rules into the debt review environment.
- Cooperate in ensuring that the debt review process operates efficiently by adhering strictly to the service level agreement with the NCR.

## **4.8 Cost of credit**

### **4.8.1 Fees and cost of debt counselling**

There are a number of debates going around the cost of debt counselling which are relevant to note from various perspectives. There are various fees involved in the debt counselling process which re:

Upfront application fees	-	R50
Debt restructuring fee	-	up to R6 000
After care fee	-	5% of repayments up to maximum of R400 for the 1st 24 months, reducing to 3% with a maximum of R400 thereafter
Sheriff's fees	-	R120 per credit agreement (or provider if debt counselling has been centralised at provider)
Legal cost	-	on a case by case basis R2 500+
PDA costs	-	R7.98 to R27, 50 depending on the amounts

We will look at the impact on debt counsellors, payment distribution agencies and consumers.

## 4.8.2 Debt counsellor impact

A number of different models exist in the current landscape:

- **Stand alone, start-up businesses:** These businesses have been the most sensitive to failure, yet were probably the ones that were intended to blossom in terms of the BEE component of the NCA's objectives. Lack of legal knowledge and legal back up services are the main reasons for the failure rates.
- **Professional practices:** Mainly, attorneys and accountants practices have ventured into providing debt counselling services. Apart from the normal aspects of commercial acumen and having business stability in place, which is relating to the experience versus the start-up nature of the first example, legal experience here seems to be a key to success. Not only can the legal firm more easily manage the legal cost, but the expertise allows them to quickly and better assess the way forward. Furthermore, the professional relationships of these firms with credit providers do significantly increase the success rate around coming to an agreement.

Debt counselling enterprises have branched out via either franchise models or by setting up branches in a standard corporate model. Set up cost and ongoing running costs differ significantly based on the model the debt counsellor operates in. Clearly, whatever the model, the revenue needs to sustain the business, hence debt counsellors will select those clients that will give them an acceptable return on effort. Research shows that the debt counselling business in spite of it being a very significant market has not actually been largely profitable. This would be concern to the NCR only to the extent that it may impact the amount of business actively in this industry as it could mean insufficient registrants remain in business to cater for the numerous consumers that are in need of these services.

*So what are the consequences of debt counsellors making business decisions for the good of their particular enterprise?*

In terms of profitability demands, clients that have little capability of repayment are typically turned away from the process, as the fees that are generated by the debt counsellors do not compensate them sufficiently for their efforts. Furthermore, the legal cost associated with the debt counselling makes it prohibitively expensive for this end of the market. Whilst there is a subsidy scheme in place, this is wrought with red tape and hence has little utilisation. It certainly does not sway the business decision to assist these consumers.

The cap on the fees means that the top end of the market, which comes with increased complexity around their financial affairs, can still only be charged the maximum fees. The next point is that businesses need good relationships with their stakeholders and hence the drive to pursue reckless credit charges is hampered by the fact that these processes run through the same people. Where the debt counsellor is dependent on a good relationship with the credit provider to settle the consumer's matters, it becomes clear that they start steering away from the acrimonious debate around reckless lending. Experience has taught the debt counsellors that information is not forthcoming to substantiate claims of reckless lending and cases have often proved fruitless. Hence a business decision is made not to pursue this route as a general rule of operation.

### **4.8.3 Payment distribution agencies**

The longer the consumer's debt restructure period, the higher the proportioned cost of payment distribution fees in the overall cost of debt counselling. It has been proposed to look at moving those ongoing fees for the low income/low repayment capability part of the market, to the credit provider. For the consumer, the cost is significant in relation to the debt, but the contention is that the credit provider is benefitting and would have incurred higher costs themselves in terms of the ongoing management of collecting the payments under the agreements reached. It has further been proposed that the payment distribution agencies could facilitate a smooth subsidy distribution back to the debt counsellor as part of their mandate.

### **4.8.4 Consumer impact**

Contrary to the objectives of the NCA, the economics of the debt counselling industry are such that the low income consumer actually receives no real benefit from the existence of the process as they are not viable clients for the industry. Subsidy schemes have failed to lower the barrier of this consumer to enter the process. The cost is capped at a certain level that benefits the higher end of the income earners, but does nothing for the low end of the market place.

The legal cost of finalising a debt counselling restructure agreement is prohibitive for the low income consumer and hence precludes this end of the market place from accessing this solution.

An example of this is that a consumer with an income of around R2 500 with a repayment ability of R450 would pay up to 21% of their debt in debt counselling cost. The cost is up from 13% if they would settled their debt during a 24 months' period. This shows how the cost of the payment distribution process starts significantly impacting the overall cost over long periods of time.

### **4.8.5 Credit providers**

In the South African model, the credit provider currently does not bear any of the direct cost other than having to provide the infrastructure to engage with debt counsellors, consumers and handle the legal process of concluding agreements (if not contest them). As an observation, it is interesting that in the UK, the full cost of debt counselling, restructuring and collection is charged to the credit provider. In the UK, this cost is furthermore capped overall at 10% of the debt.

## **4.9 Alternate dispute resolution**

The NCA makes provision for alternate dispute resolution. Whilst the Act does define alternate dispute resolution separately from the Ombuds services available, research includes the Ombudsmen in the ambit of alternate dispute resolution. It is key to an efficient working system that alternatives do exist to the more laborious route of legal (debt) enforcement. Alternate dispute resolution (ADR) is better recognised by the credit provider than the consumer and is governed not by specific NCA regulation. The consumer mostly recognises the internal process of going through the internal dispute resolution/internal Ombud of their credit provider or to

engage an attorney (either directly or via a legal insurance company such as Scorpions or Legal Wise). Although consumers know about the internal dispute resolution of credit providers, they are not necessarily using these, possibly because the objectivity is questioned on the side of the credit provider and feedback indicates *standard responses* are given and no real engagement with the consumer is taking place.

The experience of ADRs indicates that consumers abdicate their role in the process once they have handed over their complaint to an ADR. This does mean the consumer loses touch with the issue and often lacks understanding of the resolution as well as associated cost.

Consumers are not unwilling to pay for dispute resolution as there is an acknowledgement of paying for value. However, the cost should be well contained as price levels are quickly seen as too expensive.

Research indicates a need for some standardisation and accreditation at an industry level to manage the quality and protect consumers.

## 4.10 Juristics: consumers within the NCA

The NCA applies, but is limited in its application, to juristic persons whose asset value or annual turnover, and those of its related juristic persons, is below R1million and the credit agreement is either small or intermediate i.e. the agreement is not a mortgage bond or the principal debt is less than R250 000. In these circumstances the following sections will not apply:

- Chapter 4, Part C dealing with credit market practices and Part D dealing with over-indebtedness and reckless credit;
- Chapter 5, Part A, section 89 (2) (b) dealing with unlawful agreements relating to negative option marketing;
- Chapter 5, Part A, section 90 (2) (o) dealing with unlawful provisions in a credit agreement relating to variable interest rates charged on the principal debt; and
- Chapter 5, Part C dealing with the consumer's liability, interest, charges and fees.

A juristic person is *a juristic conception to which legal personality is artificially attributed by either the common law or statute.*

The NCA introduces its own definition of a juristic person to include a partnership, association or other body of persons, corporate or unincorporated, or trust if:

- there are 3 or more individual trustees; or
- the trustee is itself a juristic person, but does not include a stokvel.

This definition is in conflict with other legal definitions, even if this definition is limited to the NCA and its sphere of application.

It is argued that the National Credit Act is essentially a consumer protection legislation and that as such it should only apply to individual consumers and no other entities save with regard to regulating interest and financial charges against *juristic persons*. The NCA extends some of its consumer protection provisions to small *juristic persons* i.e. those with annual income and/or assets under R1 million. However, Section 6 (d) of the NCA excludes all *juristic persons* from being protected from usurious interest rates and financial charges.

Previously, interest charged against all debtors was governed in the same manner by the Usury Act of 1968, whether such debtors were juristic or natural persons. From the 1st of June 2007,

the Usury Act was repealed by the NCA. The NCA in terms of Chapter 5, Part C now governs financial and interest charges.

The implications of *juristic persons* being excluded from the interest provisions of the NCA are that they are now open to pay whatever the going rate would be. Whilst on new credit one may see control via market forces especially in the case of incidental credit, the juristic is now unprotected against its creditors as it comes to interest charges. The only remaining remedy for them is the in duplum rule as per the common law.

Given the large range of exclusions pertaining to the juristic entity in terms of the NCA is it not emerging clearly what the objective for inclusion of these small juristics in the legislation is. Clearly, the juristics are entitled to some of the formalities around the Act in terms of quotations etc., but the main tenets of the Act around reckless lending, debt review and interest rate and fee caps do not apply.

It also noted that the linked sureties to an agreement that fall outside of the ambit of the NCA will have no protection under the NCA even though they may well be natural persons. So generally speaking, any consumer whose residential property and associated mortgage are held in a non-incoming earning entity like a company of trust for which they as the providers of revenue stand surety, will not have access to the protections of the NCA.

## 4.11 Debt collection

In South Africa, the debt collection profession is regulated by the Debt Collectors Act 114 of 1998. The Act makes provision for the establishment of a council for debt collectors, which is to oversee and exercise control over the debt collector's profession and its inherent functions. The code of conduct was only published in the Government Gazette in 2003, which sets a standard akin to international standard.

Recovery of debt can only be done for the amount, interest and cost legally owing. Representation by the debt collector needs to be truthful and factual, also around the process being followed as the legal position.

The code of conduct governs the manner of contacting debtors and outlines times and the manner in which contact is allowed and prescribes times when it is not allowed to for instance make telephonic contact. Harassment and violence are clearly prohibited and so is the sharing of information with anyone not party to the transaction, like employers or family members. The threatening of disclosing information is similarly prohibited.

What is a notable difference in the code of conduct is that it seems to endeavour to deal with excesses this industry may experience, but it does not have provisions relating to the practical execution of its duties, i.e. around the exchange of information between credit provider and debt collector.

The NCA does not cover the methods of debt collection and is in fact silent on the matter regarding debt collection. This leaves a vacuum from a regulatory point of view, especially in scenarios where the credit control together with the collection is outsourced by the credit provider to a third party.

## 5 THE CREDIT MARKET – CREDIT USAGE, SUPPLY AND DEMAND

### 5.1 Introduction

Part of the ambit of the NCA is to provide increased access to finance for a broader base of South African consumers. In light of this, we will provide a brief overview of the current market size as well as have a look at the level of debt problems the South African consumer is experiencing. We will further look at the topical segments of the market i.e., mortgage lending and unsecured lending.

### 5.2 Size of the credit market as it currently stands

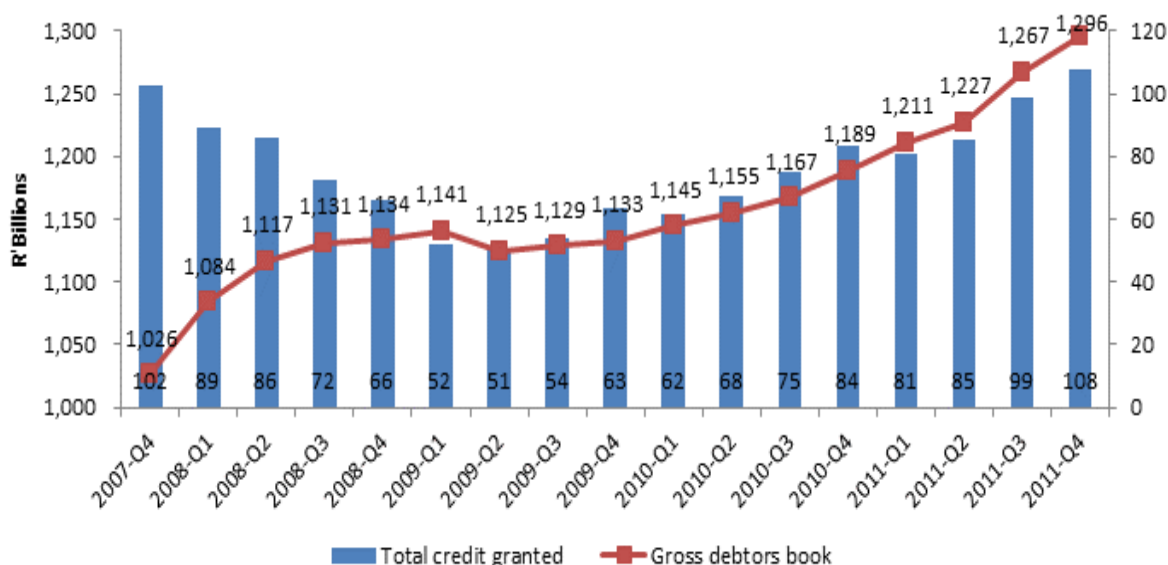


Figure 1: Size of credit market as it currently stands

Source: Consumer credit reports – various editions

Initially, after the introduction of the NCA, we see a quarter by quarter drop of credit granting in the South African market throughout this period, which resulted in an overall growth of the market – apart from Quarter 2 of 2009 where we actually note a contraction in the market. However, that also seems to be the turning point as thereafter, the actual credit granted starts growing on a quarter by quarter basis.

It is interesting to note that currently, in terms of the level of credit granting, we are back at the level of the end of Quarter 4 in 2007. The fact that we are currently in an economic environment that is significantly more subdued than in 2007, shows that there is an increased access to credit in the market.

The size of this credit market as at the end of 2011 is R1.3 trillion, with R107 billion being granted in the last quarter.



For completeness, we do note that literature indicates that over time, the reporting to the NCR has become of a better standard and more inclusive, where certain credit providers initially did not report as required. However, it is not anticipated to significantly distort the evident trends.

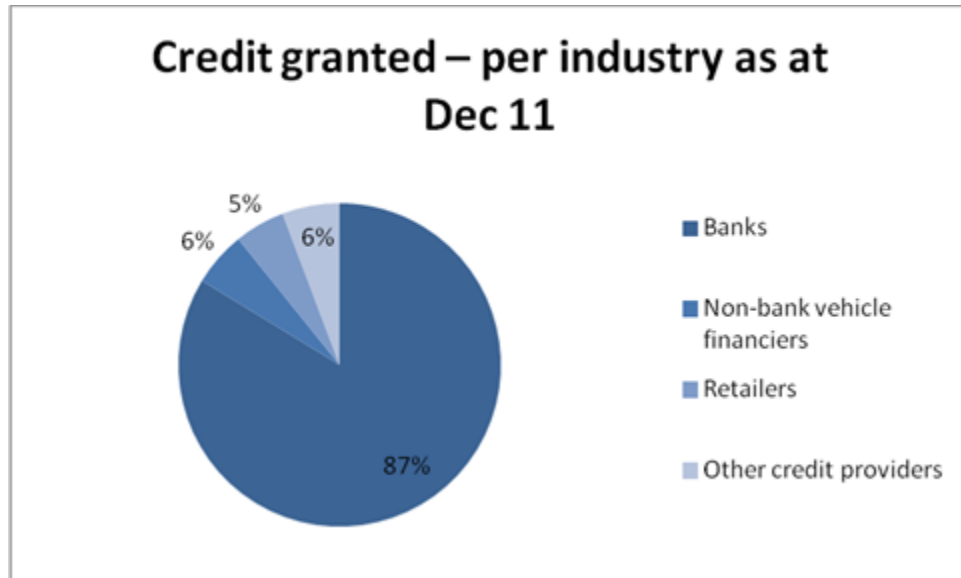


Figure 2: Credit granted - per industry as at December 2011

Source: Consumer Credit report, Q4 2011

The rand value of credit granted for 2011 is over R350 billion. It is clear from the statistics that banks are still the prominent credit providers in this space – which is why we see their viewpoints quite dominantly manifesting in all of the debates around the NCA.

### Gross debtors book in R'bn per credit type as at Dec 2011

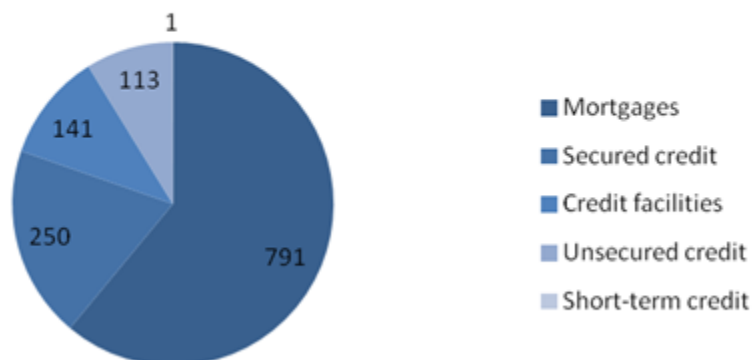


Figure 3: Gross debtors in R'bn per credit type as at December 2011

**Source: Consumer credit report, Q4 2011**

The split of the book is still very heavily weighted towards the mortgage lending environment. However, this is moving somewhat with the relative high growth that is being experienced in unsecured credit. Based on relatively higher transaction size and the relevance of home ownership in South Africa, it is not expected for mortgage loans to move from its dominant position.

The performance of the loan book is dismal at this point in time and has steadily deteriorated from December 2007.

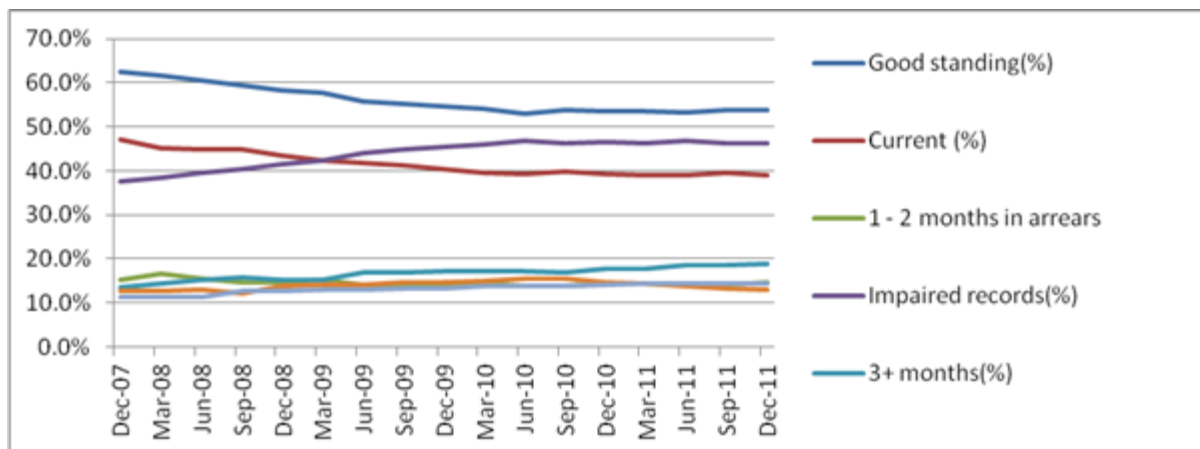


Figure 4: Repayment experience - credit standing of consumers

**Source: Credit bureau monitor, various**

Loans currently in good standing is down to 58%, with less than 40% being fully up-to-date with their payments. The remaining 19% are 1 to 2 months in arrears.

Impaired records are at 46%, which means that almost half of the consumers that have taken out loans cannot afford to repay these in the manner that was agreed at the time of lending.

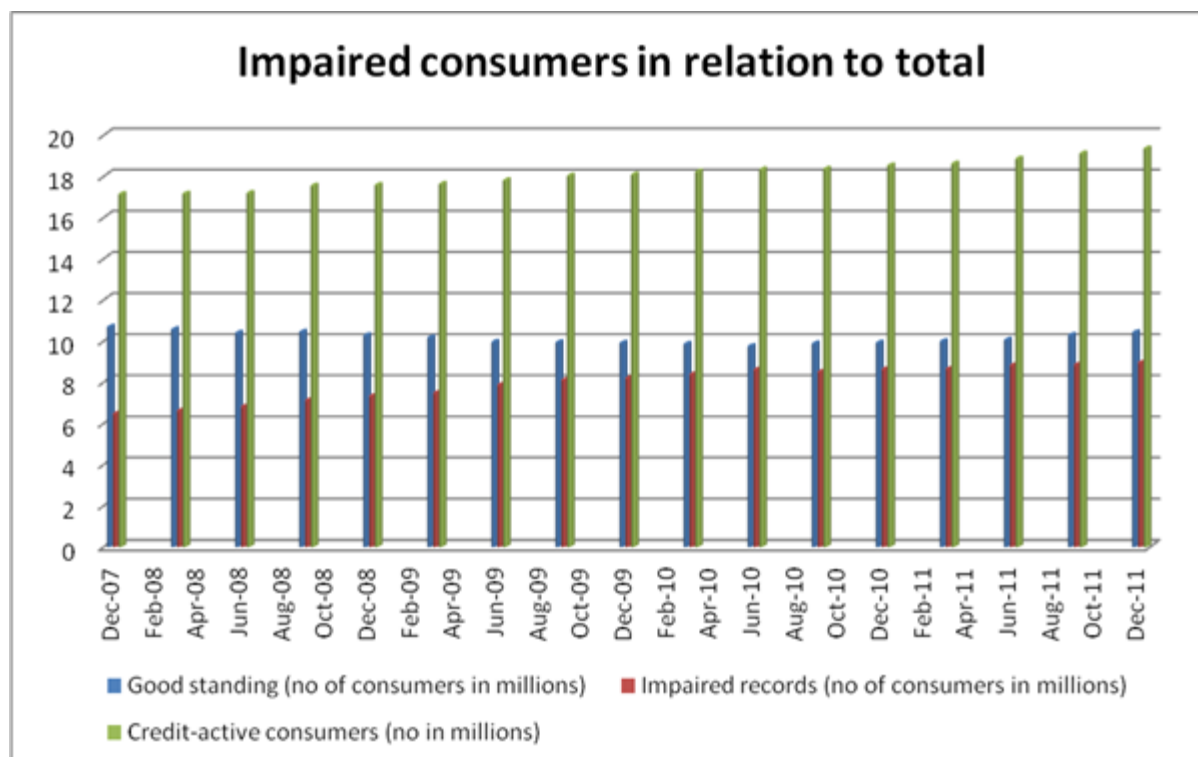


Figure 5: Impaired consumers in relation to total

Source: Credit bureau monitor, various

The above record of consumers in financial trouble is in spite of the fact that over 40% of all applications are being rejected.

Table 3: Number of consumers in financial troubles

Number of applications received and rejected	2010-Q4	2011-Q1	2011-Q2	2011-Q3	2011-Q4
Number of applications received	6,718	5,800	6,635	8,307	9,717
Number of applications rejected	2,903	2,509	2,903	3,706	4,444
% of rejected applications	43.21%	43.25%	43.76%	44.61%	45.74%

Source: Consumer credit report December 2011

## 5.3 Impact of the NCA on access

In 2006, the introduction of the National Credit Bill is being lauded as a step forward on a number of fronts. The pricing of credit and the interest rate caps contained in the Usury Act (1968) and the Credit Agreement Act (1980), which were in place before the introduction of the NCA, have not been effective in protecting consumers. Consumers have been subject to high costs of credit and exploitative practices by the non-reputable credit providers. The Act is seen as the government's approach to redress the imbalances of the past and create a more effective credit market providing access for all at affordable rates.

*So the question to be answered then becomes, did we provide more access for all in this environment?*

**Table 4: Finscope data as per annual reports (financial access)**

Finscope data – as per annual reports	2008	2009	2010	2011
Credit/loan products offered by a bank	14%	5%	13%	14%
Do not have credit/loan products from a bank, but have credit/loan products from another formal financial institution	10%	19%	12%	10%
Rely on informal borrowings	4%	2%	2%	4%
Do not have any credit products (formal or informal) – if they borrow, they borrow from family and/or friends	11%	7%	6%	11%
Do not use any form of credit products	61%	67%	67%	61%
% that claim not borrowing			75%	70%

The Finscope trends give little indication that the access on an overall basis is improving. In the trends above, we will ignore 2009 due to the inconsistency between the 2009 report and what is being used as the 2009 comparative in the 2010 report (as used above). No background explanation is offered to this inconsistency in the data. Similarly, the informal borrowing in 2010 has gone up steeply and back down again without a clear indication of the background of why this is happening.

It is noted that the self-reporting on credit data has proven to be rather unreliable. Consumers tend to understate their use of credit. In the Finscope survey of 2007 for instance, only 1% of the population admitted to having a micro loan from a formal provider, whilst no-one admitted to having a loan from an informal provider. However, 8.3 million micro loan accounts were registered at the time via the MFRC.

These incorrect responses from clients may be due to complexity and lack of consumer awareness, but also could well relate to the perceived intrusiveness of the surveyor and the survey questions. The one trend that is noted in the 2011 Finscope report is that borrowing from friends and family is on the up again. This is seen as a direct result of the current financial distress being experienced in the economy.

**Table 5: Formal and informal borrowing patterns**

	2010	2009	2008	2007
<b>Credit and loan products held – formal</b>	<b>24%</b>	<b>24%</b>	<b>16%</b>	<b>26%</b>
Store card or account	10%	19%	9%	16%
Credit card	7%	8%	5%	9%
Home loan	12%	5%	3%	6%
Vehicle/car finance through bank or dealer	5%	4%	3%	3%
Personal loan from a big bank	5%	3%	3%	4%
Overdraft facility	3%	3%	2%	2%
Personal loan from a smaller bank	1%	1%	1%	1%
Personal loan from a retail store	1%	3%	2%	5%
<b>Credit and loan products held – informal</b>	<b>12%</b>	<b>14%</b>	<b>13%</b>	<b>8%</b>
Borrowing from a friend or family	9%	12%	11%	5%
Borrowing from a local spaza	2%	1%	1%	1%
Borrowing from a mashonisa/loan shark	1%	2%	1%	n/a
Borrowing from a stokvel/umgalelo/savings club	1%	1%	1%	1%
Borrowing from an employer	1%	0%	1%	1%
Borrowing from or arrangement with pawn shop	0%	0%	0%	n/a

**Source: Finscope brochure 2010**

Again, the above shows none of the trends one would hope to see if the NCA is achieving its targets, i.e. a move from informal to formal, and an increase in the formal credit uptake, none of which trends are evident from the above.

The documentation mentions a change in question around the home loan which potentially accounts for the trend break in that number. No further clarification is provided.

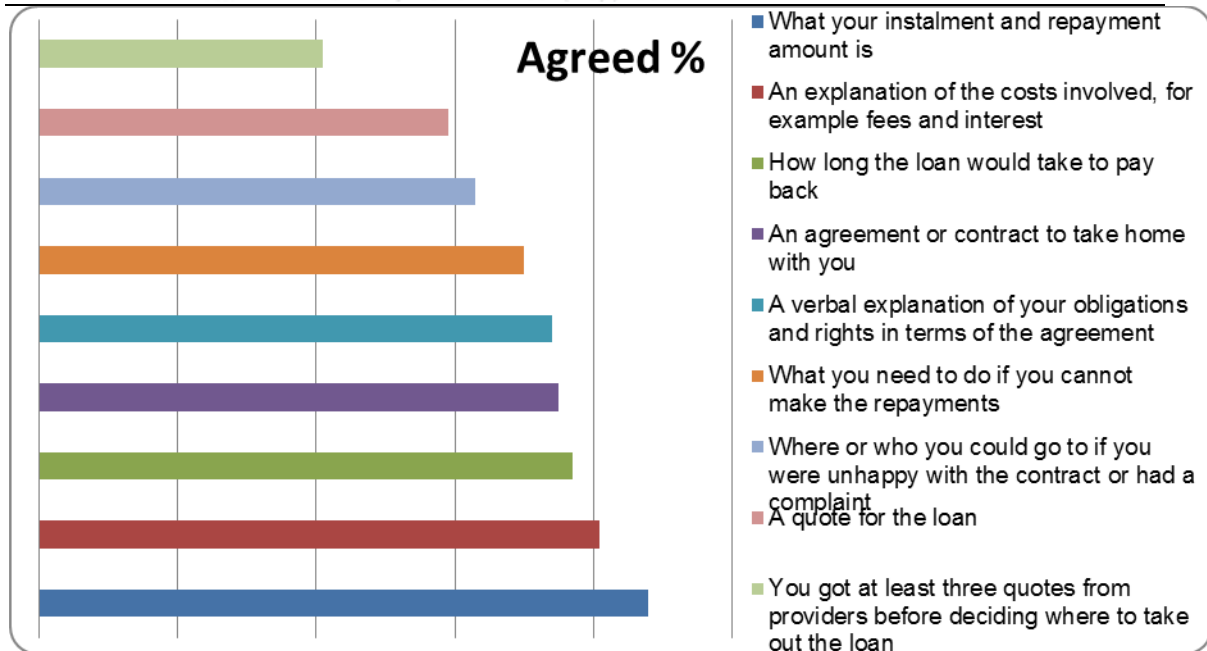


Figure 6: Understanding shown by interviewed consumers

Source: Finscope 2010

What this analysis shows is quite a high level of understanding as indicated by the consumers interviewed. However, where you go to address your problems has more limited awareness. Clearly, the fact that quotes are given when you take out a loan is known, but only in around 40% of cases do consumers obtain more than one quotation and actually shop around for the best deal.



## Heard of and understand

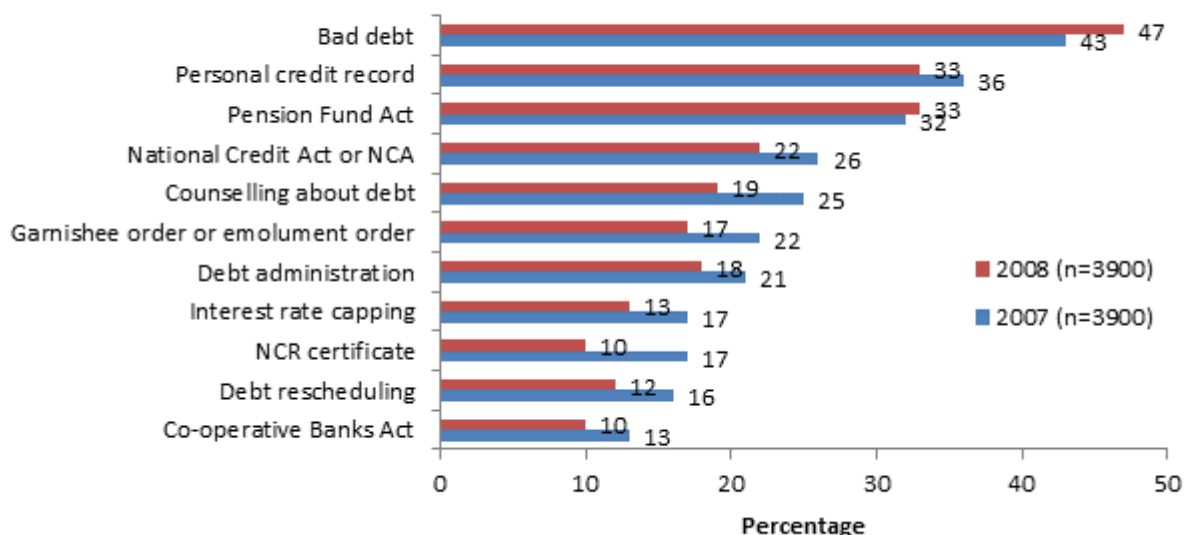


Figure 7: Knowledge of financial terms

Source: Finscope South Africa 2008 brochure

The above figure presents the level of consumer financial literacy. As presented above:

- In 2008, 47% of respondents heard and understood what bad debt is, compared to 43% of respondents in 2007.
- 33% of respondents in the 2008 survey heard and understood the concept of personal credit record. This is a decrease from the 36% of respondents who heard and understood the concept in 2007.
- 33% of respondents heard and understood the Pension Fund Act in the 2008 survey. This is not a significant change from the 32% of respondents who heard and understood about the Pension Fund Act.
- Only 22% of respondents heard and understood the National credit Act (NCA) in the 2008 survey, while 26% of respondents heard and understood it in the 2007 survey.
- 19% of respondents acknowledged hearing of debt counselling in the 2008 survey, while 25% of respondents heard admitted to knowing about debt counselling in the 2007 survey;
- 17% of respondents in the 2008 survey heard and understood the Garnishee or emolument order, while 22% of respondents understood it in the 2007 survey.
- 18% of respondents in the 2008 survey heard and understood about debt administration, while 21% of respondents heard and understood it in 2007.
- 13% of respondents reported to have heard and understood the concept of interest rate capping, while 17% of respondents heard and understood this concept in the 2007 survey;
- Only 10% of respondents in the 2008 survey heard about and understood what an NCR certificate is compared to the 17% of respondents who heard about it in 2007.
- According to the 2008 survey 12% of respondents reported to have heard and understood the concept of debt rescheduling. This is lower than the 16% of respondents who reported to know and understand the concept in the 2007 survey.
- Only 10% of respondents knew and understood the Co-operative Banks Act in the 2008 survey while 13% of respondents reported to know and understand the concept in the 2007 survey.

Results presented in the above figure shows that less than 50% of respondents in the 2 surveys of 2007 and 2008 knew or understood what bad debt is. This is a surprising statistic given the fact that South Africa has approximately 18 million credit active consumers. Judging from the figure above, it seems that the level of financial literacy did not improve between the 2007 and 2008 surveys. Unfortunately, the reports for the subsequent years of 2009, 2010 and 2011 do not capture the level of consumer's financial literacy. The above data though gives us a good indication since it is unlikely that there has been a significant change in the level of consumer awareness in a space of 3 years.

### 5.3.1 Mortgages

In 2002, the amount of mortgages granted in South Africa was around R28 billion, which soared to a height of R160 billion in 2007. In 2010, the figure is back down significantly to R37 billion. This clearly shows that there was an enormous appetite from credit providers to grant mortgages at the height of what has been described as a residential property boom in 2007. Whilst South Africa did not experience an actual subprime crisis the way the United States did, after the 2007 mortgage, extensions by credit providers began dipping significantly.

The reason mortgage loans have become less attractive to credit providers are:

- the lack of growth in the property market provides less opportunity;
- reducing value of residential property ;
- lengthening time of recovery, partially prompted by the introduction of the NCA and the delay it causes in the legal process;
- the risk experience of mortgage loans has also changed, where previously a consumer would default on other agreements first and do whatever possible to keep their home – the debt counselling 60 day period has seen consumers also stop the servicing of their home loan during this period;
- bond originators impacted margins at the credit providers (although they provided consumers with a mechanism to *shop around and compare*);
- cost of funding for long term funding has gone up significantly – i.e. the cost for the credit provider in terms of raising funds to match the long term nature of their home loan book has increased significantly, eroding the profitability of this particular type of lending.

One of the providers in the market flags the home loan as a loss leader product, provided to the consumer as a favour.

Literature shows the tightening gap between the maximum fee as charged per the NCA and the cost of funding for the credit provider. However, the majority of home loan lending is done well below the current maximum as per the NCA, which is currently 17.1% ( $5.5\% \times 2.2 + 5\%$ ) – this would equate in consumer pricing to prime + 8.1%. The actual tightening of margin seems more driven from the home loan provider's inability to adjust their pricing upwards to compensate fully for the increase in funding cost.

The impact of the cap would likely only impact the high risk part of this market where the cap would be insufficient to price for the risk taken on. Whether or not there is a *pull back* from this market, is not clear and it may not just be as a result of the inability to price for risk, but rather a view not to take that particular risk at all. Furthermore, in the high risk part of the market, potentially the collateral may present limited value in a forced sale scenario, hence prompting a move to the unsecured space.

However, the impact of the cap is presumed to be negligible if one looks at the APR across the industry. The APR is a measurement introduced that includes not only interest but also fees and credit insurance in calculating the actual cost of credit.

In 2010, the average APR across the various home loan providers (representing the vast majority of the market) was as follows:

**Table 6: APR across various home loan providers**

Mortgage value	APR - with credit life	APR - without credit life
R 280,000	9.60%	9.00%
R 650,000	9.30%	8.70%
R 1,300,000	8.90%	8.70%
R 4,000,000	8.80%	8.70%

### Feasibility, August 2011

Clearly, this rate is not anywhere near the NCA maximum during 2010 which went from 20.4% at the beginning of the year to 17.1% at the end of 2010. The credit providers are operating a lot closer to their cost of funding than they were in 2008. However, it means that the consumer does not fully pay the increased base of funding that has resulted out of tightening money and capital markets as a result of the global credit crisis of 2008.

We note from the above comparison that clearly, it is again the lower income consumer that requires the lower level of mortgage lending that does pay a higher price, although the difference does not seem significant. However, this example does show the relatively higher impact the inclusion of credit insurance has on the rate, causing a tripling of the difference between high and low income consumers.

So whilst the volume in mortgage lending has a direct correlation to the level of activity in the property market, the question remains as to whether the reduced profitability of this particular type of lending negatively impacts the ability of the average consumer to access this cheaper form of credit or not.

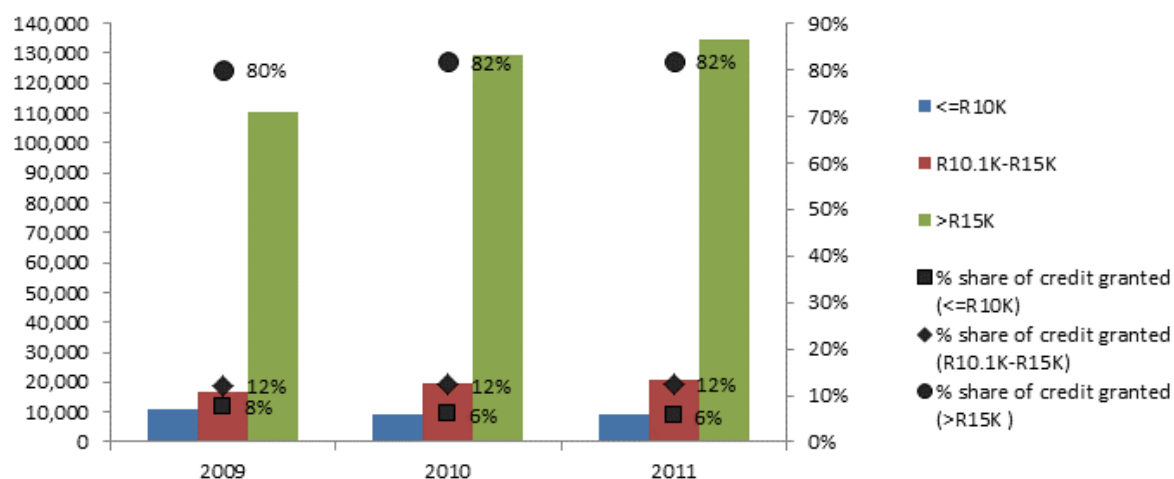
**Table 7: Share percentage of credit granted in different income groups**

Level of income	Share % of credit granted in rand terms		Share % of credit granted in number of loans	
	2008-Q4	2011-Q4	2008-Q4	2011-Q4
<=R10K (R000)	2.24%	1.91%	8.300%	5.75%
R10.1K-R15K (R000)	4.62%	6.21%	11.50%	13.66%
>R15K (R000)	93.14%	91.88%	80.20%	80.58%

**Source: Consumer credit report Q4 2008 and 2011**

The statistics show that there has been a relative decrease in both rand terms as a well as in the number of loans granted to the low income community, defined for this purpose as having a below R10 000 monthly income. There has been a slight positive shift in the R10 000 to R15 000 income category. The dominance remains strong in the higher income market. Whilst the trend does not show a positive improvement in access for the lower income earner, on the other side,

the figures do not support the contention that between 2008 and 2011 there is a significant reduction in access to credit at the lower end due to the interest rate caps in place.



**Figure 8: Mortgages granted- gross monthly income of individuals (number of agreements)**

Source: Consumer credit report, various

### 5.3.2 Unsecured lending

The growth of the unsecured loan book, accounting for around 7.8% of new lending in the 4th quarter of 2007, to 17.8% in the 3rd quarter of 2010 illustrates how important this category of credit has become.

In particular, what is apparent is the size of unsecured loans on offer to consumers. Loans in excess of R150 000, repayable over as much as 7 years, are now offered. Capitec and African Bank particularly indicate that the increase in amounts and terms are a direct result of the lack of interest in providing home loans to the market place. Whilst the purpose of this lending is not recorded, indications are that the main uses are either consolidation of other debt, deposits as required in terms of a home loan application and for incremental housing or renovations.

Clearly in the industry, this has become a competitive space for the various credit providers with even the big banks competing for growth. Concerns have been raised around the unprecedented growth in this market and talks about a credit bubble that has emerged. So far, the relative size of the exposure in relation to the main banks' balance sheets keeps this debate at bay.

**Table 8: Unsecured lending patterns in different income groups**

Level of income	Share % of credit Granted in Rand Terms		Share % of credit Granted in Number of Loans	
	2008-Q4	2011-Q4	2008-Q4	2011-Q4
<=R10K	67.70%	41.86%	80.80%	63.90%
R10.1K-R15K	15.00%	21.36%	10.10%	15.59%
>R15K	17.30%	36.79%	9.10%	20.52%

Source: consumer credit report various

The unsecured lending in terms of the income levels shows a strong move from the low income consumer as generating the majority of this type of credit coming on book towards the upper end that has in relative terms doubled their share during the last 3 years.

We note that other research which bases its detail on access by LSM, does indicate that a higher level of unsecured lending is flowing to the lower LSM's. We however do not see that supported by the consumer credit data, which we have utilised as the key data source.

### 5.3.3 Developmental credit

Developmental credit requires a supplementary registration of the credit provider in terms of the NCA like the one used for an educational loan, the development of a small business or the acquisition, rehabilitation, building or expansion of low-income housing. Loans granted by credit cooperatives to their members also fall in this category. Specialist lenders like the National Housing Finance Corporation affiliates involved in incremental housing finance would report on the Developmental Section of the NCR return.

All the main banks hold supplementary registration as developmental lenders. However, they do not complete this page on their return. It is not clear as to whether this is due to system constraints that this type of financing is rolled up in unsecured lending, or whether this actually indicates that they do not structure loans as developmental.

For instance, when it comes to study loans, many credit providers now provide these loans to the credit worthy parent, or sponsor, and no longer to the student, hence having opted not to go the developmental approach in this particular type of lending.

Reporting and data are the main missing tenets around this particular type of lending because not reporting means only assumptions are left for decision making. The preponderance of data available is submitted by the formal lending industry and it is noted that small credit providers do not necessarily submit their data thereby skewing the picture as reported for instance by the NCR in the *Consumer credit reports*. Finmark research provides suggestions for more active data collection, aggregation and publication in collaboration between the Office of Disclosure, within the Department of Human Settlements and the NCR. However, it does acknowledge the challenges in terms of under-capacity in both areas to process all the information submitted. Similarly, the compliance fatigue within banks and other lenders around the burden that legislation puts onto them is an inhibiting factor.

An optimal outcome here would be a combination of aggregating data between regulators, private lenders and data aggregators (like credit bureaus) would allow for a more comprehensive picture to emerge.

Clearly, developmental credit is a key enabler in terms of the broader objective of the NCA in enabling broader access. However, in order to make recommendations around this, qualitative research would have to be done to establish whether or not this is happening at all, and if not, what are the core reasons behind it. Legislation in itself will not create a change of direction within the credit provider space to enter into uncharted territory where they cannot either appropriately assess their risk and/or run a profitable venture.

### 5.3.4 Cost of credit to the consumer

#### 5.3.4.1 Credit life

Part of the offerings of credit to the consumer is often times the credit life component that pays ones debt on death, disability, and in certain policies, retrenchment. This clearly increases the cost of credit because it is added to the instalment. We note that these additional services are

only allowed to be provided by those institutions that also are registered with the Financial Services Board for the purpose of selling these insurance products. Whilst clients cannot be forced to take out insurance with their credit provider, they may opt to shop around and get this from any other insurance company, in reality, they more often than not default to the credit provider's options provided in order to speed up the payout process as the insurance is a condition for the payout of the loan granted.

The credit provider can also ensure on aggregate and build the cost into their overall charge for the loan, which is not transparent to the consumer. Capitec works in this manner and does pass the benefit of the cover onto the client by advertising this as *free* retrenchment and death cover.

In order to actually compare the cost of credit between providers, it would make sense to include credit life assurance into the calculation because consumers compare *apples with apples*. Given the fact that the life component is a condition of credit, cost will be incurred by the consumer (even if he/she does provide their own insurance).

### 5.3.4.2 Interest rates

The maximum rate that a consumer may be charged is based on a formula which is linked to the repo rate. Given the pace at which repo has come down over the last few years, this is seen to be at a relatively low level. It is suggested that it should have potentially had an absolute minimum as well.

The table below shows the impact of the reduction in the repo rate on the maximum prescribed interest as per the NCA:

**Table 9: Impact of reduction of repo rate**

#### ***Sub-sector/ Type of credit***

	<b><i>Maximum prescribed interest rate 2011</i></b>	<b><i>Maximum prescribed interest rate 2008</i></b>
Mortgage agreements	17.1% per annum	31.4% per annum
Other credit agreements	22.1% per annum	36.4% per annum
Credit facilities	22.1% per annum	36.4% per annum
Unsecured credit transactions	32.1% per annum	46.4% per annum
Short-term credit transactions	5.0% per month	5.0% per month
Developmental credit agreements	32.1% per annum	46.4% per annum

**Source: Feasibility, 2011, access to credit**

It is indicated that a drop in the caps as a result of the repo rate has led to the point where a number of providers are charging the maximum permissible rate to all consumers.



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### 5.3.4.3 Fee structures

Fees are governed by the NCA and quite surprisingly have not been subject to an inflationary linked adjustment schedule and they remain unchanged from the level of 2007 when the NCA was introduced.

- Initiation fees for mortgage loans are a maximum of R5 700 (including VAT);
- Initiation fees for other lending is set with a maximum of R1 140 (including VAT); and
- Monthly fees are maximised at R57 a month (including VAT).

### 5.3.4.4 Cost of credit to the consumer

The cost of credit to the consumer is the aggregate cost of all of the above mentioned components, hence the introduction of the concept of APR to help bring an understanding of what the overall impact of all costs associated with the agreement is on the consumer. One of the recommendations emanating from establishing this is through reflecting of all cost on a standardised quote template, so that the consumer can have a full understanding and has a comparative instrument in terms of shopping around for the best deal. It is also noted that these requirements should apply to agreements of all sizes.

When reviewing the actual cost, research has been done focussing on the credit provider to see if the current caps on fees and rates are appropriate. In light of this, we also come back to the debate on credit life insurance as it is contended that the growth in this ancillary product is as a direct result of the inadequate return on credit risk, i.e. the need to earn insurance commission because the interest and fees are insufficient.

So clearly, none of the credit providers is in favour of lowering caps and they point to a diminishing access to credit that would result out of this. The caps in terms of mortgage lending from a fee perspective, adjustments are encouraged whilst from a rate perspective, there seems to be no real concern at this point. It is argued that if the repo rate would further reduce, it would become an issue. Hence, one of the recommendations has been to cap the bottom level of the repo rate in terms of the interest rate formula. The other recommendation is to reduce the multiplier in the formula and increase the fixed amount to limit the effect of a dropping repo rate on the maximum rate permissible.

So if one looks at the pros in terms of increasing the caps, they are seen as follows:

- Increase of maximum interest and fees (caps) would lead to increased access. Rural and low income communities are still relying on the informal credit providers and higher caps would allow for these consumers to be brought into the mainstream industry with the relevant legal protections associated with that.
- Increased access would improve living standards as it can provide access to housing alterations, education and poverty alleviation. Credit has been proven to impact positively on income inequality providing a positive social welfare impact. It may positively impact access for (start-up) entrepreneurs and has a positive impact on consumption as a factor of economic growth.
- It is contended that higher interest rates will only apply to new clients and will not impact existing clients due to the competition factor.
- There would be a decrease in the selling of credit life. Micro lenders will be a viable enterprise within the low income and rural communities and this may lead to new entrants into the industry. Options and choice to consumers improve and heightened competition will lead to better rates, no more cross subsidisation between segments etc.

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*Ideal scenario or not?*

The cons are that higher rates and higher risk appetite could well result into higher default rates. Furthermore, increased caps could lead to a growth in reckless credit.

From an economic point of view, the level of household debt as a percentage of disposable income stands at an average of 75%, a ratio that has to come down. It is currently anticipated that the consumer will only be sufficiently deleveraged and be able to begin borrowing at normalised levels in 2014. Raising caps inevitably will push up this number. The vulnerability in the financial system and at consumer level would increase. Taking more risk from a banks' point of view, increases the requirement to hold capital, which is costly and under pressure due to increasing regulatory pressure in terms of Basel II and Basel III.

Changes are recommended to the way the caps are calculated so as to minimise the impact of a low repo rate. However, we note that there is no proven correlation that guides the setting of the multiplier in the formula that will guarantee an improved credit environment. The argument to increase the fee levels is more easily understood based on the fact that these are often seen as relating to the cost of acquisition of a loan and hence a normal inflation based adjustment is not out of the question.

## 6 EFFECTS OF PROGRAMMES AND INITIATIVES

### 6.1 Introduction

After implementation of the debt counselling process, the NCR commissioned the 2009 benchmark report on debt counselling – challenges to consumers and the credit industry in general, which researched the experiences in the 1st year after the implementation of the NCA. In this review, we will summarise the findings, as well as look at subsequent reports written at a later date to see how the report was acted on, and to also show the development of the thought process around this.

### 6.2 Main findings

The 2009 report identified various issues throughout the process which were hindering a successful running of the new concept of debt counselling.

The lack of co-operation from credit providers included the following:

- Certificates of balance – a key input in designing a debt review proposal, were either not being provided at all, or, arrived with significant delay and were often incomplete, or, incorrect.
- Copies of credit agreements were equally difficult to obtain from credit providers.
- Proposals prepared were either rejected by credit providers or no response was forthcoming at all. Counter proposals from credit providers often reflected incorrect rates.
- Banks were using their right of set-off to clear loans (i.e. they were using savings balances, or, incoming funds in transactional accounts to pay off the consumer's debts).
- Credit providers were terminating the debt review process before the 60 days were up.

In summary, the process and the administrative rigour at the credit providers led to a dysfunctional process because without correct information the next step of preparing proposals will automatically be flawed.

This is compounded by the fact that different computer software packages are used by the debt counsellors and hence proposals for similar consumer debt profiles are being solved for quite different purposes. This did further hinder getting a proposal that could be agreed upon by both parties.

All this led to a break down in the trust relationships between parties. Debt counsellors started referring matters to court. Credit providers were similarly debating legal points around geographic and monetary jurisdiction to avoid dealing with the actual merits of the cases and proposals presented to them. The spirit of the legislations seemed not to be a consideration in spite of industry engagement. They summed up their conclusions as follows:

- Provisions in the legislation were insufficient and open to interpretation.
- Industry agreements were not honoured and credit providers and debt counsellors were either not following the process, or were looking for the technicalities to abandon the process rather than focus at implementation within the spirit of the law.

- Time limits were generally a very problematic issue from both sides as information was not provided timeously by credit providers, and proposals were submitted late by debt counsellors etc.
- Credit providers were not trusted to have the right intentions.
- There was a general lack of skills and understanding.
- The use of different software packages by debt counsellors led to different outcomes.
- There were significant concerns around the Payment Distribution Agencies.

On the last point, additional research was done highlighting issues of the same administrative challenges as found with the credit providers in terms of inaccuracy, problems with debit order collections and payment confirmations, missing or mislaid forms etc., all frustrating the adherence to reached agreements.

Their recommendations were:

- train both credit provider staff and debt counsellors;
- communication, down to a level of making sure practical issues around correct fax numbers and e-mail addresses – including the potentially setting up of a database of contact details by the NCR;
- formalise the informal industry agreements – get the right, mandated, people around the table and reduce agreements to writing;
- standardise:
  - certificate of balance from credit providers; and
  - formulae and format of proposals from debt counsellors.
- implement Ombud for debt counselling; and
- amend the Act/Regulations on a number of points.

Subsequently, a debt counselling task team was appointed who in May 2010 outlined quite extensively what needed to be addressed, and how to address it. They were seeking to address the challenges by fleshing out how to make it work in real terms. So clearly, the debt counselling process has to work better in the 1st instance and referrals to courts need to be drastically reduced given the fact that now cases may take 2 years to be heard. This is completely contrary to the intention of the process which is, to resolve a consumer's debt situation and get them back on their feet within a reasonable period of time.

The tenant underpinning all of this is a collaborative voluntary establishment of a set of procedural guidelines that will make the process work. Clearly, this would require some serious commitment on the part of all stakeholders around adherence and to stop the flight into time delaying legal procedural issues that the NCA currently leaves open.

Recommendations made are to establish relevant code of conducts for the various stakeholders, a proper complaints' handling process and very detailed proposals around guidelines for the various aspects of the debt counselling process. It is quite clear that a lack of definition of a term like *reckless lending* leaves everything in the process open to debate. Having guidelines does not take all of it away but it sets a benchmark where you can establish a *suspicion* of reckless lending and by doing so, it narrows the debate.

When looking at the process a debt counsellor has to go through with a client, it amplifies that the level of skill required in doing this, like every aspect of the consumer's spending has to be evaluated and re-assessed. This is not a trivial exercise, which various other sources highlight as well, as consumers are often in denial about the fact that their lifestyle is not sustainable at the current level. Therefore, detailed guidelines of every aspect of the consumer's expenditure as

well as which points to weigh into the decision are helpful in guiding this process. The guidelines as proposed give leeway in terms of accommodating the consumer's needs. However, not all of this leeway could always be utilised if one has to come up with an acceptable number for debt reduction. The fact that *minimum percentage of income available to reduce debt* is also specified is where the counter balance comes in. Clearly, this undoubtedly iterative process of reviewing budgets/spending behaviour, requires significant people skills in combination with financial astuteness on the part of the debt counsellor.

Once established, what is it that can be cut in terms of expenditure? Which assets should and could be sold to improve the situation? is the *dividing of the amount* proportionate to the various credit providers. The recommendations around standardisation of these rules, incorporated in computer programmes which could be signed off and accredited by debt counsellors and credit provider representation would embed a standardisation of allocation of funds and approach that would also facilitate the acceptance of proposals by credit providers. Currently, the multiple packages and varying proposals do contribute to the ad hoc approach from credit providers in accepting or declining proposals presented. If the input is not consistent by implication, it is difficult to address inconsistent decision making on the part of the credit providers.

In October 2010, the following observations were made by Feasibility (Pty) Ltd in terms of the debt counselling process, which was outside the ambit of the research they were commissioned to do, but it shows the evolving thought processes around this. They made the following recommendations:

- There needs to be a review of the Declaratory Order of 2009 which has turned the process more cumbersome given the fact that all these matters have to be referred to a court even where consensus is reached with the credit provider.
- Changes have to be made so that not all Magistrate Court rules apply to simplify the process. Currently, the administration order process which is an alternative to resolving the debt situation albeit not governed by the NCA, has less of a burden in terms of affidavits and rules than the NCA process, making this process less time consuming and less costly – something that would be beneficial to the NCA debt restructure process.
- The NCR should re-open the route for uncontested proposals to be signed off in a simplified manner – whether one uses the administrative functions with the courts, like the clerk of the court, or whether the NCT widens its role. This would require the necessary capacity to be created to fulfil this role within the NCT.

A long term objective would be to engage with the Department of Justice in conjunction with the Department of Trade and Industry to establish dedicated courts whose mandate is to speedily hear and decide upon debt restructuring and related matters. The NCR will play a key role in ensuring that magistrates are correctly trained on all legislation and regulation regarding the NCA and the overall objective of the debt review process. The court process significantly delays the original intended 60 day turnaround time in terms of restructuring a consumer's debt.

The report expresses concern around the role and the cost of Payment Distribution Agencies and the disproportionate allocation of the overall debt review cost accruing to them. Recommendation is made to review cost but only in the context of the overall cost, which furthermore should be coupled with rules in respect of services provided in return for those fees. Some of these fees, in their view should become part of the cost carried by the credit provider especially for the more vulnerable consumers.

A number of other publications highlight the need to govern and regulate the PDAs. Whilst PDAs they engaged in the industry as evidenced by the code of conduct, they are seemingly flying under the radar. Their presence in the public debate is non-existent. They seem to seek no exposure in the consumer education process and lack profiling even on the worldwide web.

Bringing the PDAs into a regulatory framework would also allow for their recommendations around a more prescriptive approach to ensure that no payments for any service, or debt repayment under the debt review process, can be made outside of the PDA – compelling compliance from credit providers et al.

Their next recommendation is around setting minimum service levels for the after-care process. Every debt counsellor fulfils this role based on their individual understanding and standards, and consumers will have disparate experience depending on who they choose. Standard will provide clarity to both parties and assist in managing the ongoing process. In terms of the debt counselling industry, there is a qualitative component which indirectly also talks about providing access to debt counselling in the more underserved, low income areas. Start-up debt counselling businesses, specifically in this area, will need more support not just around the skills regarding debt counselling, but also in general business practice. Given the objective of the NCA in terms of its BEE targeting in expanded participation for designated groups in the consumer credit industry, the NCR may look to collaborate with other governmental and non-governmental agencies in assisting these start-ups.

As is the report in 2009, the October 2010 report's request is again for (further) standardisation of the Form 16 with expanded requirements regarding the disclosure of the total cost – with debt counselling charges, legal cost and PDA fees all being detailed. Credit providers provide this disclosure as part of the initiation of the transaction. The disclosure would be in keeping with the overall provisions of the NCA.

## 6.3 The stumbling blocks in the debt counselling process

In the media, it is highlighted that the fact that unsecured creditors, whilst for obvious reasons, rank behind secured ones, it does mean that they have little to gain from co-operation.

After we reviewed the commissioned research and the task team reports, we had a look at the general media in terms of what they say about the debt counselling process and its effectiveness. In 2009, the credit providers were reluctant participants in the debt counselling process, with a finger being pointed by the NCR to the big banks as the main culprits. The NDMA is quoted raising concerns around the fact that, whilst at the time, 70 000 consumers are registered for debt counselling, very few matters are being resolved – with less than 3% having been concluded.

In 2011, Wesbank highlights abuse of the 60 day restructure period by taxi owners prompted by unscrupulous debt counsellors who sell the 60 day period as a payment holiday. Unwittingly, taxi owners who are not over-indebted but could do with a bit of relief on their cash flow entered a debt review process which they ultimately did not require.

Another report in the same year also highlights the above, noting that taxi drivers managed to manipulate the system together with the debt counsellors to continue to do business unhindered for up to 18 months whilst not making a single payment on their vehicles. The same article however, also prevents the other side of this credit provider versus debt counsellor and consumer debate, in highlighting the ongoing complaint from debt counsellors around lack of response from credit providers.

In July of 2011, it is highlighted that the debt review process is struggling to function with all the disputes going on, and as little as 10% of the matters brought to the court each month were being processed.



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## 6.4 Impact of educational workshops and programmes

### 6.4.1 Consumer awareness

Research indicates that there is increased awareness around the NCA and the NCR, including amongst low income consumers. The debt counselling process and its benefits are getting greater recognition.

However, it is noted that in 2010, the awareness seems to be static and no longer growing. The actual knowledge of the underlying concepts like the consumer protection qualities of the NCA, general financial terminology, as well as the knowledge of contracting information is still limited. There is only a minimal improvement shown in the understanding, the redress and complaints mechanisms.

This is concurred by the outcome of a report where mystery shopping was done. Consumers are aware of their rights but they are easily duped, for instance, with regard to what comprises a quotation. Hence, they will accept whatever is practised in the place they are. So there is a need for greater intensity of education rights and more enforcement around bad marketing practices which still prevail in many places. Marketing in the workplace for instance, provides a validation to the credit process which is unintended as there is no endorsement by the employer but it is felt in that manner, influencing the take up of credit upwards.

### 6.4.2 The NGOs and consumers' desk

Comment on the ability of the NCR to maintain the relationships as positive. They also see the communication by the NCR regarding awareness as effective. It is however noted that the number of capacity building workshops and funding for NGOs has decreased. They also note a lack of access to debt counselling in the rural areas.

### 6.4.3 Alternate means of creating awareness

In terms of information campaigns, it is clear that lots of electronic information is available to the internet-savvy consumers as almost every stakeholder went through effort to provide explanatory notes, brochures and guidance around the NCA on their websites. One of the interesting points raised in a conference paper presented where the effectiveness of TV programmes like Soul City. Weaving the story of financial trouble into the story line of Soul City, made the point resonate. The audience's reviews mentioned across the board the applicability of the storyline in today's world, where debt and financial mismanagement is an everyday fact of (township) life. The premise to be looked at here is what talks to people and what *awareness actually sticks*; apparently, viewers remembered the debt counselling route mentioned in the series.

A Q & A run for an hour on their Facebook page, brought out numerous issues and questions that were being raised and answered. No approach will work for every group of audience, so creativity and diversification in targeted communication strategies will be important.

One of the sponsors is Old Mutual, as part of support to their *On the money* financial literacy programme. This programme teaches basic financial literacy on request to groups of people in churches and community centres around the country. This programme has successfully operated and trained thousands of people since 2005. It has now teamed up with the legends initiative for enterprise development to broaden its reach.

Another partner to Soul City is the NDMA who see the partnership as a way of entrenching messages into the consumers' minds regarding the risks of over-indebtedness as well as the avenues for debt relief. They stress the role organisations have to play in ensuring an increased level of financial literacy and see Soul City as a credible way in achieving this.

#### **6.4.4 Possible considerations**

In light of the fact that awareness seems to be stagnating and not growing at this point, it is important to consider programmes like the ones mentioned above to see if alternate means of getting the message out are more impactful. Utilising individualised approaches often have significant impact. We note the case of a health programme that was trying to create awareness around diabetes and breast cancer with women in San Diego, US and with limited funding they had tried church hall meetings etc. to get the word out with limited impact. That programme became successful when the organisers figured out that hair salons were a place where women, the target audience, were spending a lot of time and tend to chat to the hair dressers. By training the hair dressers on these health topics and getting them talking to their customers, the message was spread incredibly efficiently.

In the South African context, ideas that have been around like advertising by using video channels in taxi services and public health facilities (where people do spend time waiting), would be worth further exploration.

## 7 REGULATORY INSTITUTIONS AND/OR OTHER BODIES PERSPECTIVE ANALYSIS

### 7.1 Introduction

The role of regulatory institutions differs significantly and hence we will see differing perspectives. It is noted that regulators will only express opinions if it is within the ambit of their mandate. Hence for instance, we see commentary from the Financial Services Board around credit life insurance which is within their ambit, but not around interest levels because that is outside of their scope.

### 7.2 South African Reserve Bank

The South African Reserve Bank (SARB) has not published any extensive analysis around their view on the NCA. The South African financial system has been largely protected against the direct effects of the global financial crisis that started in 2008. The NCA is acknowledged as one of the contributing factors to this stability of our financial system.

The SARB seems to see little reason to intervene in the current credit market. The topical debate around the concerns of the high growth rate of *unsecured lending* is a good example of this – a growth rate that is mainly driven by the big four South African Banks (Absa, FNB, Nedbank and Standard). Appeals have been made to the SARB to investigate this further, but they, after initial indications to the contrary, now seem to not want to further pursue this other than looking at improving the reporting point. In light of the role of the regulator, this may well be understandable, as they are concerned about systemic risk to the banking sector as opposed to pushing a consumer agenda. The former is relatively limited given the size of unsecured lending versus the balance sheet of these banks, as well as the fact that impairments are not on the rise in this category.

The March 2012 Financial stability report confirmed moderate growth in unsecured lending by the banks, with it being about 8% of the overall gross credit exposure. The highest growth was in loans over R30 000 in other retail credit. The report indicates that at current levels, unsecured lending does not constitute a bubble and the bank is monitoring developments closely. Unsecured lending does not currently present any systemic risk to the financial system.

### 7.3 Credit Providers Association

The Credit Providers Association was prior to 2007 known as the Consumer Credit Association, and was started as a collaboration of various retailers that in the late 1980's together with the credit bureau, Information Trust Corporation and KreditInform, nowadays known as TransUnion and Experian, established the collaboration that allowed them to share consumer credit information for the purpose of granting credit in an informed and responsible manner.

Since 2007, the participants include various other companies and organisations that collect regular payments from consumers, and that provide payment profiles, such as insurance companies and telecom providers.

With the advent of the NCA, there is even a greater emphasis on the importance of maintaining up-to-date and correct data. The Association hence relooked its core function and focused all its resources into the monitoring and improvement of consumer credit data submitted by its

members to the Associate Member Bureaux. This focus has resulted in the number of records rejected by credit bureaus significantly decreasing, whilst the overall quality and accuracy of credit data held by bureaus are improving.

The counterparty to the CPA is clearly the Credit Bureau Association, whose objective it is to ensure the confidentiality, accuracy relevancy of the credit data received, and to ensure proper utilisation of such data.

Their stated objectives are as follows:

- to provide a framework of international recognised standards or information protection principles and locally applicable laws, that will serve as a guidelines for the fair and good practice in the consumer credit industry;
- to promote effective management of credit and business risk in South Africa;
- to monitor the operations of members of the association with regards to the nature and quality of information recorded, stored and reported and to ensure that members abide by the code of conduct of the association; and
- to liaise and consult, and to make representations to government authorities, subscriber associations and other body with a view to ensuring that the legislative and business environment in the country is conducive to a sustainable and well-functioning credit information system.

Other than the CPA, the CBA does seem to play an active role in consumer education where they collaborate with various NGOs to ensure that the consumer knows about their rights regarding the data kept about them by the credit bureau. These rights include the right:

- to view their profiles;
- to dispute information if incorrect as well as demand proof of information provided; and
- to the credit bureau and be compensated for the cost of having incorrect information removed.

The CPA seems to be more of a utility in getting the input correct for the credit bureaus and do not play an evident role in the public debate nor contribute to consumer education.

The Financial Services Board does not administer the NCA. However, it is important to note that specifically the Financial Advisory and Intermediaries Services Act (FAIS act) Act 37 of 2002 does impact the debt counselling process. The reason for this is that part of the restructuring of an indebted consumer's affairs may well be the change, termination or temporary suspension of insurance and investment policies as well as for example medical aids. A debt counsellor may not advise a consumer around any of these matters unless they are also a registered Financial Advisor according to the provisions of the NCA.

## 7.4 Micro Finance South Africa

Micro Finance South Africa (MFSA) clearly defines itself as the association of legitimate micro lending. They are the voice of reputable Micro Financiers in South Africa with a membership of over 1 500.

Membership of the MFSA means members are automatically affiliated with:

- Credit Ombud, Credit Information Ombud, CO (CIO);
- National Debt Mediation Association, NDMA; and
- National Loans Register/Credit Providers Association, NLR/CPA.

These ensure compliance requirements with regards to payments, alternative dispute resolution, combating over indebtedness and avoiding reckless lending – as required by legislation through both the National Payment System Act (Act 78 of 1998) and the National Credit Act (Act 34 of 2005). As a consequence of membership, they also subscribe to the credit industry code of conduct to combat over-indebtedness in terms of S 48 (1) (b) of the National Credit Act (NCA).

Clearly loan sharking, whilst illegal, has not disappeared in the townships and other low income communities; this is still a very entrenched *industry*. The *mashonisas* (Zulu for *those who bury you under*) are a legacy of the apartheid era when black people could not access credit in the formal industry. They still practice that in a manner outlawed by the NCA, by withholding ATM cards and only handing them back after pay day, once they have collected *their cut*. Violence is part of the collection methods, and the interest charged is exorbitant.

The growth of Capitec and African Bank in the last few years is however an indication that the micro lending business is viable and can be done within the constraints of the NCA. This is further shown by the increasing extension of unsecured lending by the big 4 banks. Whilst no figures exist on the informal micro lending business, it gives some indication that at least there is increased access for low income earners to credit within the formal sector, and hence within the confines and the protection of the NCA.

Concerns are expressed in the media around the fact that the credit consumer is the victim of a disparate group of regulatory bodies governing the industry and hence consumer rights being defended in various pockets instead of them being one point of reference for the consumer.

## 7.5 Banking Association of South Africa

*So what is the perspective of our formal Banking Industry in terms of the NCA?*

The recovery cost and infrastructure cost to handle debt review processes and enter into the often protracted legal processes have increased. It also means additional cost in terms of a lengthened recovery time as the credit provider has to wait significantly longer before being able to for instance sell the defaulted consumers' property in execution. The uncertainty of recovery also increases cost and all of this cost ultimately will have to be priced into the interest the consumer pays.

Whilst the direct cost of debt counselling is the consumer's to bear, the cost is the first thing recovered from any available funds the consumer has as direct reduction on available funds for the credit providers. The administrative processes of handling all of this are costly to the credit provider.

The strict rule around ensuring that a proper affordability assessment is done means that less credit is being provided. The sanction in terms of reckless lending does lead to a much more cautious approach. In this context, an observation has been made that there should be guidelines around allowing lending where it is economically beneficial rather than having a blanket approach regarding repayment affordability. It is not clear what the exact definition of this would be, as repayment ability is key to ultimately recovering the credit extended to a consumer, but we presume this to link to, for instance, asset based settlement where the collateral of the loan is ultimately intended to be sold to settle the outstanding debt, or, the project being financed will generate the funds to settle the loan.

Margins are being constrained in a low interest environment which may be contrary to the intentions of monetary policy as generally low interest are looking to stimulate an appropriate level of consumption in the economy. If however credit providers are limiting credit extension due to limited profitability, they will start counter acting what the Reserve Bank is trying to achieve in terms of setting its rate in line with its objectives. Difficulties and long delays in recovery in the process mean that the credit providers' capital is tied up for much longer. Abuse in the system of

the process to the consumers' advantage is obviously a concern to the credit provider. All of this impacts on costs and reduces the risk appetite.

An interesting point in terms of consumer behaviour does surface that consumers take a less responsible approach to debt and hide behind the NCA. Consumers are seen as reluctant to downscale their lifestyles even when necessitated by the debt burden and hide behind the protection of the NCA.

All of the delays in recovery, additional administrative and legal cost and uncertainty around recovery does increase the price of risk and will hence drive banks as well as other credit providers to seek higher returns. Ultimately, pricing is always done on an average basis since the cost of the loss is not recovered from the consumer that defaults but from the pool of consumers that have been granted credit.

### 7.5.1 The new code of banking practice

Establishing a new code of banking practice is a long consultative process. The previous code of conduct had been in place since 2004. A re-write was necessarily to add specific provisions to respond to the Jali banking enquiry (into the competitive environment of our South African banking industry with a specific emphasis on the level of bank charges in our country) as well as the CPA and the NCA.

The code provides the platform within which the Ombudsman for Banking Services adjudicates disputes between banks and their customers. It supplements the regulatory and contractual requirement that govern the customer-bank relationship. The new code has come into effect on January 1, 2012.

In the new code, the right of *set off* concept is specifically constrained to what is allowed in terms of the NCA. *Set off* is a contentious issue with consumers and debt counsellors as banks have been using this right of *set off* and appropriating all the consumers' available funds (usually on the day of salary payment) to settle the outstanding payments with that same bank. By doing this, they have been disallowing a debt review process that seeks to deal with all creditors based on the available funds.

The other contentious issue which is credit insurance is also dealt within the code, and a commitment to explain the details of available insurance adequately including ensuring that the consumer is aware that he/she has the option to utilise his/her own insurance.

Generally speaking, the code of banking practice reflects the commitment from the banking community to adhere to all of the NCA regulations and apply the principles of this legislation. It does however also highlight the responsibility of the consumer in its engagements with the bank.

### 7.5.2 Banking Association South Africa and the Micro Finance Council – perspectives on pricing

The NCA imposed 2 types of control on pricing. The 1st, in terms of restricting the maximum fee that can be charged and the 2nd is restriction on the level of interest. This means that given the fact that the Repo rate as set by the South African Reserve Bank, which is the reference rate utilised in the NCA formula to determine the maximum lending rate, is at a 38 year low of 5.5%. The interest cap is currently felt as constraining the level of interest that can be charged and it is observed that in most categories a lot of the lending is done at the maximum level.



It is not the objective of the caps on pricing to act as a control that actively influences pricing, but to set a ceiling at a level where it is deemed to be excessive so as to protect the customer. Without any controls in place, pricing of loans is influenced by a number factors, the main ones being:

- the cost of acquisition;
- the price of risk (i.e. what is the anticipated *chance* this loan is going to default and what would be our loss in that particular case); and
- how strong is the competition in this particular space.

It is important for a working credit industry that the credit provider can profitably do business. This is facilitated by them being able to price for risk across a spectrum of clients from very low risk, to high risk. Hence, it is not surprising that the credit providers via BASA and the MFC are arguing that the current caps on the fees are impacting their ability to service the more high risk part of the market because they cannot adequately price for this risk. Furthermore, it is argued that the caps on the pricing also mean that rural communities are not serviced sufficiently because it simply is not profitable to do so under the current regime. This is a sound economic argument. If there is no stretch in the price, there would be no expansion into markets or client segments that either, introduce more risk, or, that have a higher cost of acquisition and servicing as it would not make sense from a risk/return, or, cost/return point of view.

However, the argument must be considered in light of the parties bringing this to the table as whilst one cannot find fault with the theory, one also cannot simply say, increasing the caps and fees would automatically ensure a broader access to credit. Other considerations will influence credit risk appetite for the credit providers as well as their expansion strategies.

Mortgage lending is potentially less sensitive to the pricing, but more to other factors. Mostly, the lower end of the market is quite heavily hit by the increased conservatism in credit granting because they cannot meet the requirements of high deposits. These consumers also lack the entrenched relationships with banks that allows them continued access since banks have started seeking to retain their client base rather than grow it.

The caps on interest rates for mortgages are not viewed by the *big banks* as a massive restraining factor on the granting of these facilities. There are other bigger influences at play which are:

- The ability to effect security. In terms of Basel II, the measure for loss is quantified as LGD (Loss Given Default), which indicates the percentage the bank is expecting to lose on average in terms of consumers not being able to pay.

This calculation is sensitive to the time value of money. So, if the recovery process would become less efficient due to the NCA hurdles in terms of the various sections of notification etc, the LGD would increase. A higher LGD would result in a materially lesser appetite for lending.

- Payment rules determine that the smaller unsecured loans can run via NAEDO, which is a payment mechanism that prioritises these debit orders in the queue, collecting them ahead of other payments. Mortgage payments, because of the generally higher amounts, cannot be run via NAEDO, so they may only hit the consumer's bank account once the funds have dried up already. This influences the probability of default negatively and thereby increases the LGD.
- Ability to re-price is limited. Generally, market practise is that loans and concessions against the prime lending rate are given for the term of the loan. Internationally, termed as best practise, there is the ability to re-price as it allows for fixed rate agreements which

are renewable on expiry but will be priced in accordance with the funding cost. Banks argue that this allows for more competitive, yet balanced credit market.

There is a different perspective on the latter point where credit providers are making international comparisons around their lack of ability to re-price existing home loans. The ability to offer fixed rate periods more readily is only approached from the angle that it gives mortgage loan providers an opportunity to re-price. However, fixed rate periods in more stable interest rate environments offered to consumers are actually very long. A quick look at the Netherlands gives us fixed interest rates offered for periods of up to 20 years, whilst in South Africa, a consumer would struggle to fix an interest rate beyond 2 years on his home loan.

Fixed interest rates have benefits to consumers as it protects them against the down risk of increasing interest rates. Actually, South African banks are in a prime position to re-price their books as every change in the repo rate by the Reserve Bank triggers a reset of the variable interest rates on the majority of home loans granted. Whilst we currently are used to seeing prime move exactly in line with repo, each bank sets their own prime rate and can choose to move their prime rate independent of the repo changes. This clearly has competitive implications, but the regulatory environment does not constrain the banks. Historically, we have seen this breakaway from exactly following repo by various banks during the 1998 rapid increase on the prime rate.

We further note that the fact that rate concessions are valid for the full life of the loan has been mainly driven by competitive force. In the late '90s it was not uncommon to be granted the interest rate concession only for the first 2 years of a loan, to be re-assessed on expiry of the concession.

Furthermore, during this period, JIBAR linked loans, rather than Prime linked rates did gain some favour. Using a link to JIBAR gives the mortgage lender a quick (mostly quarterly) adjustment to the changes in the interest rate environment protecting their margins.

Hence, it seems it is mostly the competitive environment that impacts the ability of mortgage lenders to re-price since they are not constrained from a regulatory perspective.

## 7.6 The Financial Services Board

The Financial Services Board (FSB) is not a regulator in terms of the NCA and hence only touches sideways on this universe.

Two important points here are that clearly debt counsellors are not in a position to change insurance, investments and medical aid cover in place as part of the review and/or restructure of the consumers' financial commitments. They cannot advise clients around these aspects of their finances unless they are also registered in terms of FAIS, for which they would have to meet the appropriate standards of competence.

Another factor that services quite prominently in the debate around pricing is the application of credit life insurance. We discussed earlier in this report the different models in place and the relevance of this to the overall pricing of credit. What is a key matter around this is that the FSB has expressed concern over the premium rates being used for credit life insurance. The argument commonly used is that premiums are higher given the fact that these types of insurance do not require normal risk underwriting, read no health checks and test, and therefore, the risk is higher. However, it is indicated that the increase level of premium does exceed the increase in cost of risk significantly and much higher profits are being made – part of which is being passed back to the credit providers via commissions and joint ventures.

Credit insurance is quite a separate offering and not easily replaced by something that is available in the market place, especially retrenchment insurance, which is not offered by the life insurance companies as a standalone product.

The FSB's deputy executive in charge of insurance, has publicly stated the FSB is concerned about the terms and conditions under which the banks force borrowers to take out high-cost short-term insurance. As the key tenant of FAIS, the act governing the sales of these products, is about ensuring the client is being provided the right advice in the choice of product, it is evident why the question has been raised as to whether or not credit insurance is sold in contravention of the Act since no alternatives are being provided, and the people selling the credit insurance (together with the loan) are not FAIS compliant.

We quote from a 2011 Guidance Note from the FSB to indicate exactly this,

It is not feasible to sustain an argument that, where relatively complicated matters regarding insurance cover must be explained to (unsophisticated and often illiterate) consumers, including the exclusions provided for in the policy, and the fact that the consumer has a choice between an existing policy and one offered by the dealer, that the person interacting with the consumer on these matters, does so in an administrative, clerical or technical manner or in a subordinate capacity and does not require the person to exercise judgment. Furthermore, a transaction in respect of a financial product almost invariably results. Accordingly, typically neither of the exclusions from the definition of *representative* will apply in such instances, and the argument that the person concerned should not be required to meet the fit and proper requirements of a representative, cannot be sustained.

In other words, the sale of credit insurance needs to stand up to the scrutiny required in terms of the regulations.

The issue is not new but it got extensive attention early after the introduction of the NCA and an enquiry was held at the time appointed by the Life Offices' Association (LOA) and the South African Insurance Association (SAIA), was chaired by Judge PeetNienaber, the retired Ombudsman for long-term insurance. The main aim of the enquiry was to identify and eradicate undesirable practices prevalent in the consumer credit insurance market negatively affecting consumers.

The panel of enquiry was guided by the following terms of reference:

- improper and inappropriate marketing and distribution practises;
- the payment of excessive commissions or other improper fees or incentives;
- the fairness of standard terms and conditions;
- the adequacy of the overall value provided to consumers;
- pre- and post-sale disclosures and information provided to consumers; and
- promoting greater consumer understanding of credit life products, their benefits and the consumer's rights.

There are different types of consumer credit insurance products available to the consumer:

- **Credit life insurance** can be issued under a long-term or short-term policy and is designed to cover the outstanding balance of the money owed to the credit provider by the person whose life is insured should this person die, become disabled, develop a critical illness or become retrenched. Credit life insurance is available for the following credit transactions:
  - personal loans;
  - overdraft facilities;
  - student loans;

- credit card facilities;
  - mortgage bonds; and
  - asset financing.
- **An extended warranty** is marketed by motor dealerships or retailers on behalf of short-term insurers. This type of cover is designed to indemnify consumers against the risk of mechanical breakdown of the insured vehicles or goods like electronic equipment purchased. It normally comes into effect on the expiry of the manufacturer's warranty.
  - **Top-up or shortfall cover** is a short-term policy and is designed to cover the shortfall between the amount still owed and the insurance payout in the event of loss or damage to the vehicle, furniture or appliance.
  - **Minor chips and dents cover** is a short-term policy issued under a short-term license, and provides cover for minor damage to the bodywork of a vehicle, which usually falls within the excess of comprehensive car insurance.
  - **Car and home owners** insurance is defined by the National Credit Act as part of the term *credit insurance as covering loss of or damage to property* and must therefore be considered a type of consumer credit insurance cover.

The findings at the time around the sustainability of the consumer credit component as a proposition were in principle positive. Nienaber said at the time that it is however also important that consumers realise that they are not passive parties to consumer credit insurance policies. *The consumer has a duty to be vigilant as to how the policy affects his or her interests. This includes reading the contract. While consumers must be placed in the position where they can make informed decisions, they must then take responsibility for these decisions.*

Their main recommendations at the time were as follows:

- intermediary remunerations:
  - no support for further price regulation.
- consumer awareness:
  - seen as a collaboration effort and responsibility between regulator, industry bodies as well as consumers – the relevant quote here is *Consumer activism is an imperative for truly effective market regulation.*
- market conduct:
  - the problem is not the regulation but the monitoring and investigation of non-compliance; and
  - the requirement for standardisation of disclosure to consumers is highlighted.

We highlight the items specifically referring to the NCA below:

- Disclosure is the cornerstone of consumer protection. Therefore, there must be clarity of who gets paid for the provision of the services other than the insured itself which would include the credit provider if they are selling the policy.
- Consumer credit insurance is often sold as part of a package when a credit transaction is concluded. Unless the consumers' attention is specifically drawn to the credit insurance transaction, they may not be aware of its existence.
- Hence it must be clearly stated who the insurer is, what the premiums are etc. In addition, consumers should be advised to inform their families of the existence of the cover and its importance.

- Single premium payments were definitely a malpractice prevalent in the consumer credit insurance industry, but this has thankfully been outlawed by the National Credit Act.

So what did the panel conclude ultimately that would have far reaching consequences if fully implemented?

- Consumer credit insurance is different from other forms of insurance. It cannot be separated from credit. Its principal beneficiary is often not the consumer but the credit provider. Consumer credit insurance should accordingly be treated as a category separate and distinct from other forms of insurance.
- Whoever controls credit should also control consumer credit insurance.
- One of the main purposes of the NCA is to provide for the general regulation of consumer credit. This Act already contains a section that deals specifically with credit insurance with the aim of ensuring consumer protection.
- The members of the panel believe that the NCR should assume control of market conduct of consumer credit insurance as well as of intermediary remuneration where it is regulated.
- This will require appropriate amendments not only to the NCA itself but also to the long- and short-term insurance Acts and the FAIS Act. The LOA and SAIA codes may also require revision.
- A key recommendation of the Nienhaber report was that the principal regulatory control of consumer credit insurance should rest with the NCR. In their view, the NCR has the manpower and the means at its disposal to exercise such control.

Much more simply put – they recommended a complete shift of the regulatory burden through to the NCR.

## 7.7 The Banking Ombud

The Banking Ombudsman clearly is the Ombud for the banking sector, which includes any matters relating to credit agreements. Therefore, a banking client would not turn to the credit Ombud, but the banking Ombud for resolution of complaints. This may sound confusing to a consumer but the credit Ombud and the banking Ombud are operating a joint call centre ensuring that the consumer does not necessarily have to understand the difference. They will be guided to the correct place. In its latest (2010) annual report, it gives the NCA ample credit as follows:

The National Credit Act (NCA), introduced in 2007 essentially to save South Africans from themselves by preventing unmanageable debt, has undoubtedly met this aim, with the demand for credit dropping as consumers become wiser and more circumspect, and banks more stringent with their lending criteria. However, this success has come at the expense of the normal flow of property sales, which, some commentators point out, is at conflict with the government's drive towards home ownership for all citizens.

It is further noted that mortgage-related complaints fell from 22% of total workload to 18%, which the Ombud points as a possible indicator of the impact of the NCA.

As early as 2007, the bank Ombud has been very supportive of the NCA and sees it as a sound piece of legislation as it prevents reckless lending and protects consumers against over-indebtedness. They note that after the initial cautiousness, with a slowing turnaround time for



loan approvals, things gradually settled down as everyone became familiar with the process. They see the NCA as meeting its objective of minimising risky loan agreements.

## 7.8 Credit Ombud

The Credit Ombud's mandate spans all credit providers except for the banking industry. In 2010, the mandate of the Credit Ombud was significantly widened, which the chairperson welcomed as follows:

During the course of 2010, the office of the Credit Ombud was approached by the credit industry, the debt counsellors and Payment Distribution Agents, as well as the National Credit Regulator to incorporate and provide an Ombud's service for debt counseling matters, i.e. when a consumer goes into debt review. This meant changes to our governance structure and documentation as well as approval by the Financial Services Ombuds Schemes (FSOS) Council, which was duly granted. The office of the Credit Ombud will ensure compliance with the various codes of conduct adopted by the credit providers, debt counsellors and Payment Distribution Agents. This further extension of mandate means a full circle in the credit and credit information life cycle, providing a one-stop service. Dealing with debt counselling matters by the Credit Ombud will certainly lessen the volumes of the already clogged up judicial system.

This would certainly be a welcome relief to the overburdened systems currently trying to deal with all these matters.

## 7.9 Competition commission

For the NCA to establish its overall objectives, a competitive market is a key prerequisite. Hence, it is not surprising that in the enquiry, the Competition Commission held in 2006 – 2007 around the competitive environment within the South African banking sector; the NCR was one of the parties presenting their views on this.

There are a few aspects to this. Payment processing is important to facilitate both the credit as well as the debt restructuring process; hence limited cost in this space is beneficial to a consumer. The converse also being true, that if there is no cost effective/open to the competition, the payment charge can be used to *load* the cost of credit. In this context, the NCR also raised the high cost of returned debit orders – a matter that is reflected in the competition commission's findings.

Clearly, there is a challenge in providing access to credit that require innovative ways of doing this in expanding the foot print of credit providers and allowing for different approaches. Access to the payment mechanism in a *free and fair* manner is key to facilitating credit processes. The concerns around high penalty charges are echoed at the enquiry by Micro Finance South Africa.

The final report of the *Competition commission* highlights that, in terms of pricing, a number of other categories of penalty fees charged in the past by South African banks are now outlawed in terms of the National Credit Act.

- Honouring fee (Excess Item or Excess Availment Fee). These fees are charged when a bank makes the exceptional decision to honour a cheque or debit order presented for payment against an insufficient balance, based on the bank's knowledge of, and relationship with the customer in question.



- Late payment fees on credit cards. This is a fee charged when the minimum payment due on a credit card is not received by the following statement date (i.e. payment is a month or more late).
- Over limit fees on credit cards. This is a fee charged when a customer exceeds his/her credit card limit

The competition commission summarised the matter as follows. *Reliance on debit orders is widespread throughout the mass market served by banks, and it is notable that debit order facilities have recently been added to the basic Mzansi account offerings.*

In accounts typically held by lower income customers, a relatively high proportion of debit orders presented for payment are dishonored for insufficient funds. This means that the burden of penalty fees is falling disproportionately on those least able to afford them. Where detailed data has been provided, indications are that *as much or even more* revenue is earned by banks from rejected debit orders on these accounts than from the processing of successful debit orders.

Many ordinary bank customers are not in a position to pad their bank accounts with funds that are surplus to their immediate needs. They face the situation where and when credits such as salary payments are delayed. This causes the debit orders which they have signed in good faith to *bounce* for insufficient funds. It is not a matter of neglect, or irresponsibility, but of circumstances beyond their control. Yet the penalty fee is applied per debit order items so that a customer may face multiple penalties to add to the primary misfortune of getting paid late. Customers on low incomes with tight credit margins can readily find themselves lacking sufficient funds without having had any intention of defaulting on their payments, or, of breaching their undertakings to the bank.

It seems to us quite unacceptable that a bank should recover more than the cost incurred in processing the rejections in such cases. It is no answer for banks to say that on application, they might reverse the penalty fee in a deserving case. Many consumers, even if they were assured of the possible indulgence would suffer in silence rather than muster the confidence, or find the time to challenge the debit when it appears on their account.

We recommend that a cap be imposed on the price of processing rejected debit orders at approximately R5 per dishonored item. We have no reason to believe that, currently, banks would be unable fully to recover their costs ordinarily incurred in respect of rejected debit orders within such a cap.

However, this was never enforced subsequently although we have seen some banks take on the R5 recommendation and have applied in their entry level banking segments.

## 7.10 Twin peaks model – new proposed regulatory framework?

The Twin peaks approach is a form of regulation based on objective and refers to a separation of regulatory functions between two regulators – one that performs the safety and soundness supervision function, and the other that focuses on conduct-of-business regulation. The Twin peaks approach recognises the different skill sets required for prudential and market conduct regulation.

Prudential regulation is designed to maintain safety, soundness and solvency of financial institutions or funds, while market conduct regulation requires the perspective of a customer, which is a different regulatory perspective and philosophy. It is inevitable that market conduct regulation and prudential regulation will frequently overlap and conflict. It is also understood that

while it may be relatively easier to separate prudential and market conduct regulation in banking and insurance, it may be more difficult in financial markets, securities and pension funds.

### 7.10.1 Twin peaks model – international examples

The Twin Peaks model was adopted first in Australia following the Financial System Inquiry (Wallis Commission) which was reported in 1996. The Netherlands followed in 2002.

In the United Kingdom soon after May 1997 General Election the new Labour government announced the creation of a single regulator Financial Service Authority (FSA). Twin peaks was rejected in the UK in favour of a single integrated regulator. In June 2010, the UK coalition government announced that it was committed to establishing a Twin peaks structure.

The reasons for the UK to later establish the Twin peak model were because the single regulator was probably never appropriate for a financial system of the size and diversity of the UK. Much more attention to crisis management was required and the tide turning back in favour of central bank involvement in regulation, with Twin peaks as preferred structure.

The Twin Peak Approach proposes a fundamental shift from the way in which the financial sector is presently regulated. Under the proposals, there will be two principal regulators:

- A prudential regulator will be responsible for the prudential supervision (safety, soundness and solvency) of the entire financial sector. At the moment, both the Bank Supervision Department and the Financial Services Board (FSB) have prudential oversight responsibilities in terms of their respective legislation). This structure will also allow for macro-prudential regulation (for example, managing systemic risk across the entire financial sector) which is the renewed focus of international regulators in the aftermath of the global financial crisis.
- A market conduct regulator that will be responsible for supervising market conduct (for example, regulation that restricts or sets standards for the conduct of financial services firms).

The twin peaks approach (Australia, Canada and the Netherlands) separates regulatory functions between at least two regulators – one that performs the prudential supervision function and the other that focuses on business conduct regulation. This approach is designed to garner the benefits of the integrated approach (regulatory consistency, jurisdictional clarity and informational efficiency), yet also addressing the inherent conflicts between prudential regulation and consumer protection.

### 7.10.2 Need for the Twin peak model for South Africa

The country's financial services sector is an integral component of the socio-economic development. The sector enables economic growth, job creation, building of vital infrastructure and sustainable development for South Africa. Though South Africa was insulated from the global crisis as a result of sound macroeconomic fundamentals, there is still need to ensure that the South African financial systems remain competitive and that it is made safer through regulations that follow best practices.

South Africa is committed to a financial regulatory reform agenda aimed at strengthening financial stability and has set for itself the following objectives:

- financial stability;

- consumer protection and market conduct;
- expanding market access through financial inclusion; and
- combating financial crime.

Therefore, in order to achieve the above stated objectives, the major policy shift is to move towards a modified *Twin peaks* model where different agencies are given the lead responsibility for key policy objectives.

The proposed reforms are designed to transform South Africa's financial sector by separating *prudential* regulation – which looks at the integrity of the whole financial system from that of *market conduct* – which protects the consumer, thereby creating a *Twin peaks* regulation model.

The *Twin peaks* approach is regarded as the optimal means of ensuring that transparency, market integrity, and consumer protection receive sufficient priority. Given South Africa's historical neglect of market conduct regulation, a dedicated regulator responsible for consumer protection, and not automatically presumed to be subservient to prudential concerns, is probably the most appropriate way to address this issue.

In addition, the existence of separate prudential and market conduct regulators may be a way of creating a system of checks and balances, thereby avoiding the vesting of too much power in the hands of a single agency. It should be noted however that, the flip side of creating checks and balances is the need to carefully define roles and responsibilities to avoid duplication of work and jurisdictional overlap. Moreover, separation of prudential and market conduct regulation does not eliminate the possibility of conflict between them. Hopefully, consultation between the two bodies will lead to an acceptable compromise. But if not, some external means would need to be found to reconcile objectives. In South Africa, the formal way of resolving conflict will be through the Council of Financial Regulators.

Operational independence is an essential prerequisite for an effective regulatory regime and for maintaining a fair and equitable financial system. Institutional, regulatory and supervisory independence is necessary to create the right incentive structure for regulators and supervisors. Regulators must therefore operate independently, without fear, favour or prejudice. Operational independence includes the freedom to approve, disapprove and revoke licenses, decide to conduct an on-site examination, as well as take enforcement action (or to recommend that another government agency take action) against a person, or, entity based upon evidence of violation of a law or regulation.

### 7.10.3 Impact of the *Twin peaks* model in South Africa

The discussion below presents the envisaged impact of the proposed *Twin peaks* model on South Africa's financial sector in general and to the NCR/NCA in particular.

The potential benefits of the *Twin peaks* model to South Africa include the following:

- reduced cost and complexity of compliance;
- enhanced coherence of regulatory reports;
- better public reporting;
- promotion of international standards;
- maintenance of the financial sector's soundness and stability; and
- reduction of systemic risk.

A Council of Financial Regulators will provide inter-agency coordination between different regulators on issues of legislation, enforcement and market conduct. The council will comprise:

- the heads of key financial regulators such as the Bank Supervision Department (BSD), the FSB and NCR;
- agencies such as South Africa Revenue Service (SARS) and the Financial Intelligence Centre (FIC);
- relevant standard-setters such as the Independent Regulatory Board of Auditors and the Accounting Standard Board; and
- non-financial regulators such as the Competition Commission and officials from **the dti**.

The Reserve Bank will be given lead responsibility for prudential regulation and the Financial Services Board (FSB) for consumer protection account must be taken of the work of the NCR. As part of this, the mandate of the Financial Services Board will be expanded to include the market conduct of retail banking services. Finally, National Treasury will encourage greater access to financial services through a range of initiatives.

The *Twin peaks* approach recognises the different skill sets required for prudential and market conduct regulation. Impact or implications of the Twin peaks model will entail the following:

- While the mandate of financial stability lies with the Reserve Bank, other regulators (market conduct regulators, as well as the NCR) must also take into account the financial stability implications of their activities and assess all systemic risks potentially arising from any institutions that they may be supervising.
- National Treasury strongly supported the efforts of the Competition Commission in highlighting the weakness and opacity in market conduct practices, and is therefore proposing that as part of the shift to a Twin peak model of regulation, the market conduct role of the Financial Services Board (FSB) will be expanded by creating a dedicated banking services market conduct regulator within the FSB, which will work closely with the National Credit Regulator. This will mean substantially stronger market conduct regulation at the Financial Services Board (FSB). To ensure this is comprehensive, FSB responsibilities will be expanded to include overseeing the market conduct of banks, including developing principles on how banks should set their fees, how these fees should be reported and what constitutes fair and unfair behaviour.
- Market conduct standards will be strengthened particularly in the retail banking sector. Despite strong oversight by the NCR and the FSB, such powers need to cover the full range of retail banking, including the regulation of banking charges and other practices such as those identified by the report of the Banking Enquiry Panel established by the Competition Commission in 2008.
- The proposal under the *Twin peaks* model is that a separate retail banking market regulator be established in the FSB, taking account of the work of the NCR which covers both banking and non-banking credit:
  - it will also be important to strengthen the current Ombuds system so that it is more in resolving disputes that cannot be settled by customers and their financial institutions;
  - it is necessary to assess the impact of having 2 separate regulators covering different aspects of market conduct in the retail banking sector (transactional banking in the FSB and credit extension in the NCR); and
  - how best to coordinate the work of the 2 regulators.
- Most financial institutions are subject to a number of regulators (for instance, many banks in South Africa also have an insurance arm, so they are regulated by both the Bank Supervision Department (BSD within the Reserve Bank, the insurance registrar within the Financial Services Board (FSB), the Financial Advisory and Intermediary Services registrar, as well as the National Credit Regulator (NCR)). Although most regulators effectively fall under the Minister of Finance, some key regulators are accountable to other Ministers (for instance, the NCR is accountable to the Minister of Trade and

Industry). In such a case, the lack of coordination between, for example, the NCR and the BSD could pose significant systemic risk to the entire banking system.

### 7.10.4 Implications

The proposed above would have significant implications on the management of the NCA. What is not clear is how the NCR would be impacted in its mandate around non-bank credit providers, debt counsellors, credit bureaus etc.

Alignment of handling bank and non-bank credit providers is not without merit, but a micro lender is not a bank and requirements around the execution of compliance aspects may well differ. Closer alignment with the FSB will provide opportunities to more broadly explore the challenge of financial access as access to credit should not be solved in isolation of other financial access.

The role of the NCR in the financial stability of the system does get acknowledged in this work, which is a good recognition and it may provide for a better platform for engagement. Currently, we clearly see the concerns of the NCR around the growth of unsecured lending not really meeting minds with the SARB's focus on systemic risk; closer alignment may benefit these debates.

## 8 CONSUMER PROTECTION

### 8.1 Introduction

Consumer protection legislation is there to promote and protect the basic rights of all consumers. Movements support the Consumer protection legislation by demanding that consumer rights are respected and protected. They also protest against market abuses and social injustices which undermine these rights. There is a World Consumer Rights Day on March 15, and in 2011 the theme was **Consumers for fair financial services**.

The year 2011 was a memorable year in the history of consumer protection in South Africa. The much-anticipated Consumer Protection Act, which aims to promote and advance the social and economic welfare of consumers, came into effect on April 1, 2011. The National Consumer Commission has been established to implement the new Act and ensure that all South African consumers are fully protected against unfair business practices.

### 8.2 Background to consumer legislation

The need for consumer legislation has emanated out of the fact that before the introduction of the NCA, there was no effective consumer legislation in South Africa. The Consumer Affairs (unfair business practices) Act provides for the prohibition or control of unfair business practices but provide no list to define these practices. The Act gave the Consumer Affairs Committee (CAFCOM) the authority to investigate, who would then report to the Minister of Trade and Industry. If the minister agrees that a business practice was indeed unfair, he will publish a notice in the Government gazette and it will be regarded as a criminal offence. It is therefore impossible for businesses (with associated sanctions) to ignore such notices. Whilst the Act had significant powers in terms of drastic measures, in reality, there was limited enforcement.

Furthermore, the Act and the committee have no power to order compensation to the consumer who has been duped by the unfair practice. Clearly, this is difficult to understand for a consumer who raised an issue. Sometimes a consumer gets a purchase price back as a result of an investigation, but no damages are paid at all.

The NCA and subsequently now the CPA (Consumer Protection Act) have a significant innovation in terms of the powers of the National Consumer Tribunal, which certainly has more capacity as they now have the ability to impose penalty. However, it does not have the power to order damages to consumers, unless it is part of a pre-negotiated proposal presented to them for a consent order.

**The dti** still sees a significant role for industry codes of conduct and self-regulation. The success of this is dependent on having an industry body that has the capacity to monitor the industry and deal with transgressors effectively by having appropriate sanctions in place which can be managed and controlled. An example of this is the Advertising Standards Authority where the print and broadcast media belong to the organisation, and the sanction is the withholding of advertising time and space.

Self-regulation is often more effective than government regulation because experts in the industry are able to identify genuine abuses quicker than government officials, and legitimate activities are less hampered by compliance rules. Codes of conduct also are easily adjustable to changing circumstances. **The dti** supports business codes and may make them part of statute if necessary, as provided for in the consumer legislation.

Common law reliance is not all that easy and arguing the following points is often complex to prove:



- defective consent – the consumer was pressured into the contract;
- deception of consumers – the consumer was misled and provider incorrect or incomplete information;
- unfair contract terms; and
- liability of defective goods.

All of these are not clear cut and consumer rights are much easier to defend these points. The NCA and CPA hence have substantial sections dealing with unlawful agreements and provisions. This changes the way in which courts deal with contractual disputes.

Consumer law is a necessary part of our legal infrastructure so as to make sure that the free market works in a way that considers both the interests of business and consumers. It does not go unnoticed that this does come at a cost for business and impacts the effectiveness of the economy. However, without consumer legislation and the South African market being increasingly opened up to international trade, we could become a dumping ground for unsafe and substandard products.

The consumer has to be enabled without prohibitive legal cost, to address their rights to counter balance the dominant role played by businesses that are supported by very sophisticated marketing strategies.

## 8.3 The CPA

The Consumer Protection Act 68 of 2008 is fully effective from April 1, 2011. It seeks to promote fair business practices and to protect vulnerable consumers such as, low-income communities and minors.

The CPA is based on the eight fundamental consumer rights that are internationally recognised:

- right to equality in the consumer market;
- consumer's right to privacy;
- consumer's rights to choose – includes cool off periods, rights to cancel transactions and examine the goods;
- right to disclosure of information;
- right to fair and responsible marketing;
- right to fair and honest dealing;
- right to fair, just and reasonable terms and conditions (also deals with prohibited transactions); and
- right to fair value, goods quality and safety (includes safety recalls and liability for defective goods).

In terms of the CPA, the National Consumer Commission (Commission) is the regulator responsible for enforcing the CPA by promoting informal resolution, receiving complaints concerning prohibited conduct or other contraventions of the CPA. They investigate and evaluate such matters and issues and enforce compliance notices. The NCC replaces the CAFCOM and all staff of the Office of the Consumer Protector have moved over to the NCC structure. The Commission can refer matters directly to the National Prosecuting Authority or the relevant court. It can also investigate matters and in agreement with the investigated party (respondent) propose the terms for a consent order from a court or from the National Tribunal.

The CPA and the NCA do not actually overlap as the credit agreements per se, and all matters governed by the NCA are excluded from the provisions of the CPA. This is also clearly stipulated in media releases by the National Consumer Commission.

However, what the CPA does is expand the protection for consumers. For instance, in the case of a vehicle purchase and finance, the loan agreement is governed by the NCA but the purchase of the car and issues around warranty and defects on the car are governed by the CPA.

Therefore, the CPA in a sense is another piece of the consumer protection puzzle that compliments what was already established by the NCA. The legislation aims to not create overlaps and conflicts between the two sets of legislation. The question remains as to whether or not the distinction is always completely clear to the consumer. This may occur in cases where the CPA governs certain aspects of the initial marketing activities from a credit provider, but all steps from credit assessment through to contracting are governed by the NCA. It is clear that the CPA will still bring its challenges in terms of bedding down and dealing with guiding the consumer through the various options in terms of exercising their rights.

The Department of Trade and Industry's annual report for the Year ending March 31, 2011 confirms the complementary nature of CPA and NCA and refers to the NCA as *National Credit Act, 2005 (Act No. 35 of 2005)*, which has thus far made inroads in curbing reckless lending and spending. It is further clear from the budget allocation on monitoring of the NCA that they are seeing this as business as usual – there are no large consulting fees noted indicating that the effectiveness needs significant investigation.

## 8.4 Interaction between the CPA and the NCA

One the difference between CPA and NCA is the extent to which entities are governed by the respective acts. In terms of the NCA, credit transactions entered into with juristics with a turnover or asset value R1 million or above are excluded and the NCA does not apply. Thus, these agreements cannot be classed as credit agreements in terms of the NCA.

The CPA exempts credit agreements in terms of the NCA from CPA applicability. The CPA's threshold for transactions by juristics as consumers to fall outside of the CPA is R2 million. The CPA would hence apply to credit transaction entered into between juristic persons with a turnover or asset value of greater than R1 million up to R2 million. This gives rise to debate as whether the CPA now expands the reach of the NCA and to what extent is this new category of consumer now protected around their credit agreements. It is not clear what underpins the difference in approach between the 2 Acts in terms of defining a small juristic as a consumer.

## 8.5 Consumer behaviour

In 2005, a report was published by US researchers with findings of research done in South Africa in which they investigated the impact of marketing strategies in the cash loan industry. This research predates the NCA and highlights some interesting points on consumer behaviour. What they established is that, it is not just the information but also the manner in which it is presented that significantly impacts the take up of any offers for financing.

They found amongst others that where the client was only presented with one rate and one repayment scenario on the marketing letter, they were more likely to take it up. Presenting comparisons in the marketing material with other providers has limited effects as opposed to when it is expressed in actual rand values, i.e. reflecting interest differentials has very little impact on the client itself.

This is a key learning point in terms of the way the NCA has been implemented. As consumers do not have the level of financial literacy to understand the impact of a difference in interest rate percentage, they would mainly rely on the rand values presented. However, they obviously are

also influenced by the terms of the loan. They are hence more likely to choose the loan with lower repayments (higher rate but longer term), rather than the one with the better interest rate.

Other interesting points were that:

- men were significantly more inclined to take up the loan if the letter was written by a woman and her picture displayed; and
- follow up phone calls making suggestions around the potential utilisation of funds had a positive effect on the take up.

So whilst the NCA is clearly regulating certain activities as inappropriate practices to solicit credit business, the drivers for take up of credit are quite subtle and certainly it is clear that consumers can be pushed to take up more credit, even while staying strictly within the ambit of legislation.

## 8.6 Consumer vulnerability

Based on the MDB consumer vulnerability index, it is noted that consumers still feel financially vulnerable although ten quarters of positive economic growth were registered since emerging from the recession in Q3 2009. This shows that the economy has not yet recovered to the necessary extent that enables consumers to experience financial stability.

Moreover, since South Africa is an open economy that is susceptible to changes in international economic circumstances, there is a likelihood that consumers will remain in financially vulnerable territory for future quarters, due to the deteriorating economic environment in especially Europe. In this context, most analysts expect international economic growth to slow down dramatically in 2012. Recently, the International Monetary Fund adjusted its expected international economic growth rate for 2012 from 4% down to 3.3%.

Some other items to note are that the improvement in confidence is partly a result of interest rate stability as repo has been static for relatively a long period. A change in that which is expected towards the end of the year would drop these levels.

The index further points to a lack of savings ability, as well as the pressure of expenditure inflation on the consumer notably, food inflation, escalating petrol/transport cost and municipal charge place.

Research in the context of this report focuses on the consumer's ability to service debt and ensuring that debt is granted in an appropriate manner. However, debt repayment is only part of the consumer's monthly expenditure, and the general increase in the cost of living does negatively impact the consumers' ability to repay their debt.

This enforces the previous raised point that credit assessment standards should be developed in order to consider this component of *cost of living* in more depth in the application process. In this light, further work may be necessary for disclosure of commitments made by consumers at the credit bureaus even if they may not be termed direct credit, akin to the manner in which telecoms submit data to the bureau.

An understanding of the impact of this increase in cost of living in an economy where below inflation type increases have become a reality, would also provide the NCR with insights as to what extent the credit market drives the level of over-indebtedness and to what extent external factors drive the consumer into a position of being over-committed in terms of all his/her obligations.

## 9 UNINTENDED CONSEQUENCES

### 9.1 Unsecured lending

The current debate around the concerns of the high growth rate of *unsecured lending* is a good example of this – a growth rate that is mainly driven by the big four South African banks (Absa, FNB, Nedbank and Standard). Appeals have been made to the SARB to investigate this further, but after initial indications to the contrary, they now seem to not want to further pursue this other than from a reporting point of view. In light of the role of the regulator, this may well be understandable since they are concerned with systemic risk to the banking sector as opposed to pushing a consumer agenda. The former is relatively limited given the size of unsecured lending versus the balance sheet of these banks, as well as the fact that impairments are not on the rise in this category.

The background to the growth is that the NCA provided a cap on unsecured lending and hence it became an attractive proposition now for banks to enter into this market. They have mainly grown the unsecured lending into the higher income segments.

Media reports indicate now that banks prefer to give consumers unsecured lending rather than to increase their home loans which usually have a much more preferential rate. Mortgage lending has become a lot less attractive to banks due to the higher cost of funding of these long term loans as well as due to the fact that the risk weighting for these loans has increased in terms of the capital adequacy rules. The reality is that the value of the collateral (house price) is no longer ever increasing and the time to attach the house (legal process) and sales takes much longer.

### 9.2 Consumer behaviour

One of the other unintended consequences is the manner in which consumers use legislation to their advantage in inappropriate ways. This is seen in a lessening sense of responsibility as the NCA should have made sure that they could afford loans and should sort out their problems. But, if the consumer does not scrupulously detail and fully disclose their income and expenditure picture, the credit provider may well arrive at the incorrect decision.

Another consumer related concern is the *use* of the 60 day period (time to establish a debt restructure plan), which has been seen and used as a payment holiday. This specifically has impact in the vehicle and even more the mortgage lending space – where historically consumers would prioritise these payments over everything else for fear of losing crucial assets like the car and the house, the 60 day period.

### 9.3 Inability to restructure loans

The NCA is aiming to ensure that assistance is provided to consumers that get into financial difficulty. However, the *reckless lending* test is problematic when it comes to credit providers re-assessing loans in a situation where some financial stress exists.

For example, historically, a credit provider may have been prepared to capitalise the client's arrears and extend his payment terms on a loan in a situation of envisioned temporary financial pressure. Post NCA, credit providers are very hesitant to renegotiate terms as this would be seen as a new contract, which would have to meet the affordability test. In case of financial difficulty, a new agreement could more easily be termed reckless and hence the credit provider rather sticks with trying to enforce the historic agreement than to risk entering into a new (more manageable) agreement for fear of it being deemed reckless.

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## 9.4 Mortgage lending

We have touched on this quite extensively before, but it is noted as an unforeseen consequence that the recovery on mortgage lending would be quite negatively impacted by the NCA. This is as a result of the lengthened recovery period and the uncertainty added to the process by the debt review and other NCA implications.

This has led to a pricing up of home loans and lesser availability. We specifically note the reluctance to increase existing bonds to provide consumers credit at the most favourable rates. The housing market is still far from buoyant after the 2008 credit crisis which increased the risk aversion in mainly the banking sector as the main provider of mortgage finance. The lack of available finance in itself further depresses the market.

## 9.5 Compliance burden

NCA compliance comes at a cost to the credit provider. This is not insignificantly given that new legislation like the NCA came with new reporting requirements, changes across legal agreements, forms and systems in use in a credit provider's business as well as the cost of training of front line and support staff around these processes. Ongoing internal monitoring as well as engaging in legal court cases to clarify principles and industry engagements to set up ways of working, all have a price tag.

Given that most credit providers have owners/shareholders requiring a return on the equity they put into the business, this inevitably leads to price increases to the consumer it is trying to protect.

## 10 COMPARATIVE ANALYSIS

### 10.1 Introduction

The analysis on different countries below dwells much on credit regulation with regard to consumer protection with much emphasis on the importance of financial literacy as a means of ensuring more financial inclusion.

Much of the findings and discussions on credit consumer protection frameworks in the different countries is based on the World Bank Policy research working paper of 2011 entitled *Consumer protection laws and regulations in deposit and loan services: a cross country analysis with a new data set*.

Essentially, the paper contributes to the debate on the topic of consumer protection in financial services by providing an overview of consumer protection issues, as well as empirical analysis on the links between consumer protection and financial sector outcomes, drawing on the new unique cross-country data set on financial consumer protection. The data used in the paper comes from a survey of financial regulators from over 140 countries conducted for the annual *Financial access survey* by the Consultative Group to Assist the Poor (CGAP) and the World Bank Group in 2010. The survey only covers credit and deposit services, and does not include investments, pensions, insurance or other financial products.

### 10.2 Significance of consumer protection frameworks

Consumer protection in the broader sense refers to the laws and regulations that ensure fair interaction between service providers and consumers. Government intervention and regulation in the area of consumer protection are justified on the basis of inherent information asymmetries and power imbalances in markets – with producers or service providers having more information about the product or service than the consumers.

A consumer protection framework generally includes:

- the introduction of greater transparency and awareness about the goods and services;
- promotion of competition in the marketplace;
- prevention of fraud;
- education of customers; and
- elimination of unfair practices.

An effective consumer protection framework includes the following three complementary aspects:

- laws and regulations governing relations between service providers and users as well as ensuring fairness, transparency and recourse rights;
- an effective enforcement mechanism including dispute resolution; and
- promotion of financial literacy and capability by helping users of financial services to acquire the necessary knowledge and skills to manage their finances.



## 10.3 Main findings of the Financial access survey

Broadly, the results of the survey of financial regulators from over 140 countries conducted for the annual *Financial access* survey by the CGAP and the World Bank Group in 2010 showed the following:

- most countries have some form of consumer protection legislation in place, but the consumer protection legislation does not often address concerns specific to the financial services industry;
- enforcement mechanisms are weak – partially due to lack of resources, institutional capacity and limited enforcement powers of regulators; and
- although effective third party dispute resolution mechanisms are essential to implementation of the law, such mechanisms are not common.

The survey covered the following main aspects of the consumer protection framework:

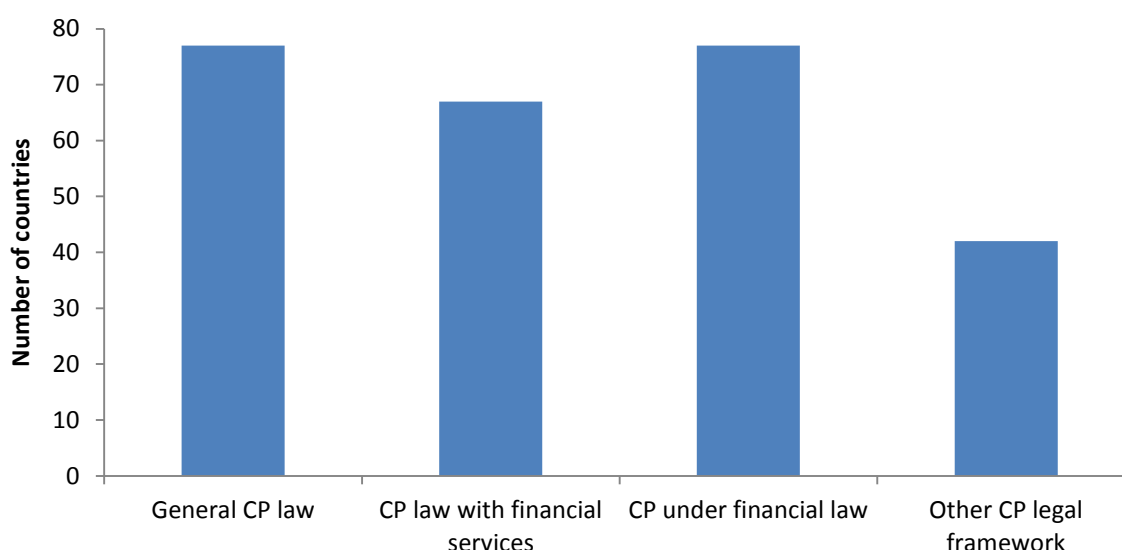
- scope of existing legal framework;
- supervisory and enforcement powers; and
- recourse mechanisms.

## 10.4 Legal framework

### 10.4.1 Existing legislation

- Among the 142 countries responding to the survey, 118 report having laws containing provisions relevant for consumer protection in financial services – most of which were passed, or, revised in the last 2 decades.

These laws and regulations usually fall into one of the following broad categories as shown in the following figure.



**Figure 9: Countries that have legislative frameworks on financial consumer protection**

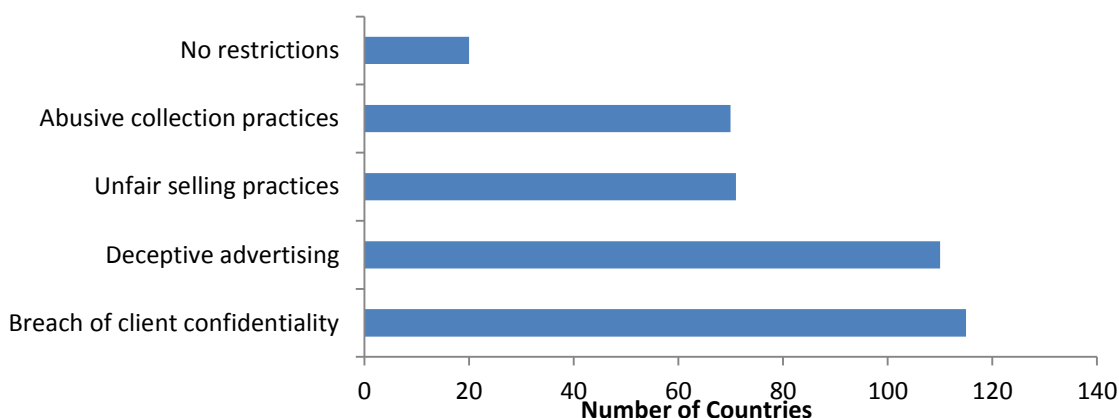
Source: Adapted from Policy research working paper 5536

- a general consumer protection law without explicit reference to financial services (77 countries);
- a consumer protection law with explicit reference to financial services (67 countries); and
- a consumer protection regulations within the framework of financial sector legislation (77 countries).
  
- In most countries, legal provisions relevant for financial consumer protection are diffused in multiple legislation:
  - 36 countries have all 3 types of legislation in place;
  - 45 countries have both a consumer protection with an explicit reference to financial services and consumer protection regulations within the framework of financial sector legislation; and
  - a number of countries report having financial consumer protection provisions contained in other laws – including laws on payment systems, credit bureaus, pensions and securities.
  
- Consumer protection legislation is in a state of constant change, with a number of reforms having increased since the beginning of the financial crisis in 2008.
  
- In the survey, 56 countries reported reforming consumer protection in financial services, with reforms taking place in both developed and developing countries:
  - Madagascar and Moldova are introducing consumer protection laws; and
  - France, the US and the UK all reform the structure of the regulatory bodies in charge of financial consumer protection.
  
- Overall, the responses to the survey indicate that basic legal framework for consumer protection is in place in most countries though it may not be comprehensive in terms of its coverage of the issues pertinent for financial services.
  
- The survey considers 2 broad sets of consumer right provisions:
  - fair treatment ; and
  - disclosure.

## 10.4.2 Fair treatment provisions

The purpose of the consumer protection regulation is to ensure fairness.

- Fair treatment provisions covered by the survey include restrictions on:
  - deceptive advertising;
  - abusive collections;
  - unfair or high-pressure selling practices; and
  - breach of client confidentiality.
  
- In the survey, 123 countries (87%) have at least 1 of these provisions covered by the legal framework.
  
- Even though the majority of the countries in the sample have fair treatment provisions in place, these provisions are often not comprehensive and do not necessarily address financial products and services.
  
- The figure below shows the number of countries that have laws that restrict unfair practices



**Figure 10: Number of countries with laws that restrict unfair practices**

Source: Adapted from Policy Research Working Paper 5536

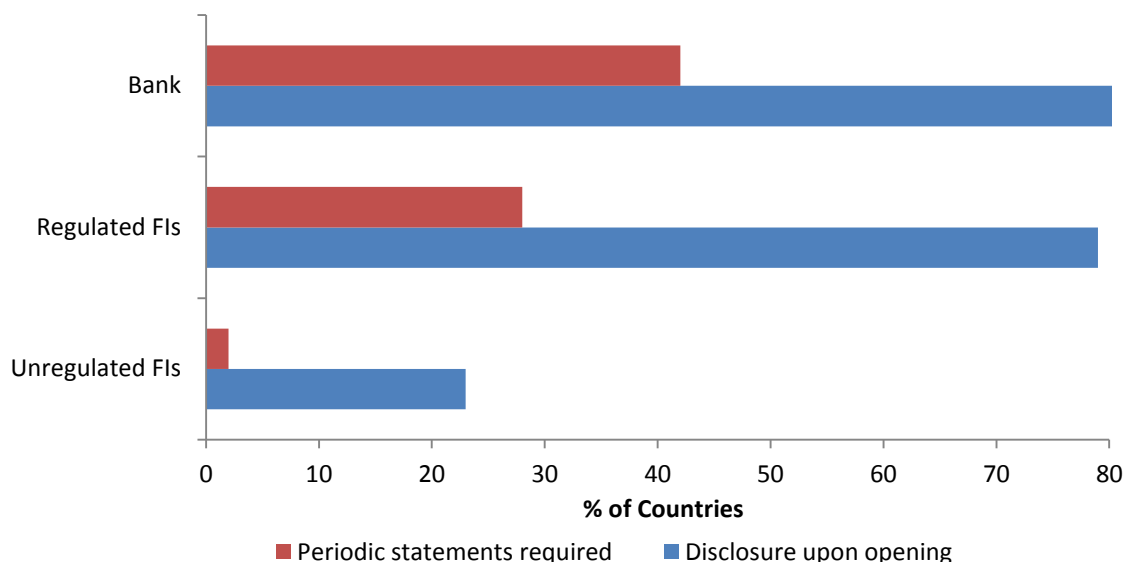
- Confidentiality issues have been historically protected by bank secrecy provisions in most civil law countries and is implied in contractual law in common law countries.
- Similarly, restrictions on deceptive advertisement in many countries are part of a general commercial law and basic consumer protection legislation.
- The survey also found out that only about half of the countries have provisions restricting unfair and high-pressure selling practices, and abusive collection practices.

### 10.4.3 Disclosure requirements

Disclosure rules focus on requiring financial service providers to disclose information on the terms of financial products in a standardised manner to enable comparison. Disclosure may be required at the following times:

- at the time of advertising or promoting a service (pre-sale disclosure);
- at the time of signing a contract (account opening);
- during the period of contractual relationship (periodic through regular statements);
- occasional, when terms of service change;
- disclosure requirements cover a broad range of contract characteristics that must be disclosed to the client at the account opening stage or during the period of the contractual relationship; and
- at least some form of disclosure requirement regarding financial products and services is reported by 115 countries (81%).

The survey covers disclosure at account opening and periodic disclosure in detail only focussing on deposit and credit services



**Figure 11: FIs that have to disclose upon opening and periodically**

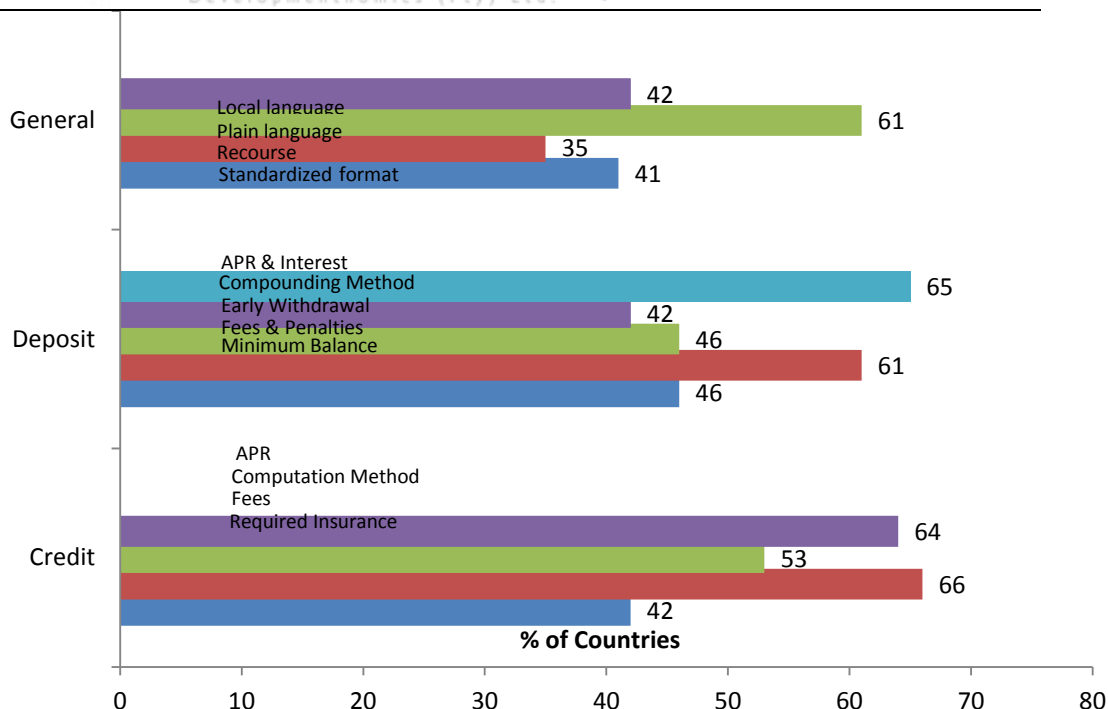
Source: Adapted from Policy Research Working Paper 5536

The figure above shows that:

- banks are more likely to be subject to disclosure requirements than other types of financial institutions;
- disclosure requirements upon opening are more common than periodic requirements, regardless of the type of the institution;
- 66 countries 46% require banks by law to submit periodic statements to customers;
- 39 countries 28% require other regulated financial institutions to submit periodic statements to countries; and
- 4 countries 3% i.e. United Arab Emirates, Macedonia, Poland and Venezuela require unregulated institutions to submit periodic statements to customers.

The type of information to be disclosed depends on the type of financial product.

The figure below plots the percentage of countries that have each of the disclosure requirements the survey sought to find out for each financial product.



**Figure 12: Percentage of countries that have disclosure guidelines at account opening**

Source: Adapted from Policy Research Working Paper 5536

The figure above shows that:

- 61% of the countries that responded have plain language requirements;
- 42% of the countries that responded have local language requirements (the need to inform clients in local language may be particularly important for low income clients);
- 41% of the countries that responded require the financial institutions to have a standardised format, such a one-page *key facts* document for disclosing information; and
- 35% of the countries that responded require disclosure of recourse rights and processes, without which disclosure requirements are practically non-binding.

In total, general disclosure requirements beyond *plain language* which can be difficult to enforce, are present in less than half of the countries.

Overall, disclosure requirements at opening of loan and deposit accounts are focussed on rates and fees, and to a lesser extent, on the manner in which these rates and fees are computed.

The figure above shows that:

- 65% of the countries in the sample require yields and/or interest rates to be disclosed at account opening to depositors;
- 61% of the countries in the sample require the disclosure of fees and penalties at account opening to depositors;
- 42% of the countries in the sample require the method of compounding to be disclosed at account opening to depositors;
- 46% of the countries in the sample require the disclosure of minimum balance requirements at account opening to depositors; and
- 46% of the countries in the sample require early withdrawal penalties to be disclosed at account opening to depositors.

Overall, only 37 countries 26% reported all 5 disclosure requirements are in place at account opening.

The state of disclosure requirements for credit services is more or less similar to that of deposit services.

The figure above shows that:

- 54% of the countries in the sample require the APR to be disclosed;
- 56% of the countries in the sample require disclosure of fees;
- 57% of the countries in the sample require the disclosure of method of computation; and
- 42% of the countries in the sample require disclosure of information on insurance (often mandatory).

Periodic disclosure becomes more important for products where the cost of the product depends on the use – such as credit cards, or, overdraft facilities.

Although periodic disclosure requirements are not as commonly imposed as disclosure requirements upon account opening in all types of financial institutions surveyed, they are predictably more widespread for credit products. The *Financial Access* survey showed that:

- about half of the countries require periodic statements to include outstanding balance for deposits and loans and fees charged for the period;
- frequency of required periodic statements differs across countries:
  - the majority of countries 64% require statements on a monthly basis from banks, 9% on a quarterly basis and 20% on an annual basis; and
  - for other regulated financial institutions, the pattern is similar.
- frequency of periodic statements also varies depending on the financial product:
  - for example, in Malaysia, loan statements have to be provided to customers at least once a year, while for deposit accounts, a statement has to be provided at least once a quarter;
  - in Greece, monthly statements must be provided to credit card holders only; and
  - in Norway, the law specifies that statements be provided annually, but the institution is required to provide the customer with a statement more frequently if the account has been in use (credited or debited). As a result, a statement is usually provided monthly.

The use of electronic statements in periodic disclosures provides a low-cost option for delivering periodic statements to the customers. It is important to ensure that customers have a choice in which form they receive their statements, as most low income customers, especially in developing countries, may not be able to access their statements.

In addition to requiring disclosure by financial institutions, regulators themselves increasingly take steps to improve transparency in the markets. A number of countries regularly post fees and rates for deposit and credit products on the regulator's websites, in newspapers and the media.

#### 10.4.4 Institutional structure

- The survey found that institutional arrangement for effective implementation of the legislation may be limited.
- On being asked to report whether or not there is a dedicated unit or department tasked with implementing financial consumer protection regulations, only 2/3 of the 99 regulators that reported they were responsible for at least some aspect of financial consumer protection had a designated unit, or team to work on these issues.



- Further analysis also indicates that these units or departments often handle a broad range of other tasks.

Implementation of financial consumer protection laws and regulations relies on regulatory and supervisory agencies. The effectiveness of this institutional structure to a large extent determines the success in the implementation of the existing legal framework.

Countries take different approaches to supervising and enforcing consumer protection, reflecting variation in legal frameworks. Multiple regulators are often involved in overseeing consumer protection in relation to financial services. In countries with broad consumer protection legislation in place, the agency responsible for implementing this legislation may also have a responsibility for consumer protection in financial services along with other goods and services. Financial regulators, including central banks in many countries often also have a responsibility for overseeing consumer protection in financial services as part of the business conduct regulation of financial service providers.

Each approach has its challenges. The institutional approach to regulations, where for example, a central bank implements consumer protection provisions in relation to regulated financial institutions, excludes unregulated financial service providers. Such an approach also poses implementation challenges as it would likely entail multiple regulators with varying levels of capacity. A functional approach, with the focus on the service received by the consumer regardless of the type of the provider, can address the problem inherent in the institutional approach. However, agencies responsible for implementing broader consumer protection such as consumer protection authorities, competition authorities, or ministries of trade and industry, often face the challenge of assuming the responsibility for financial consumer protection as they lack the capacity and knowledge of the financial sector.

Regardless of the chosen approach, effective implementation of the law requires clearly defining the role of the agencies involved and assigning a single entity for handling complaints and inquiries by consumers. In recent years, several countries established a single agency responsible for consumer protection issues for retail financial services. Among them are the following:

- Financial Consumer Agency of Canada; and
- National Credit Regulator in South Africa.

The United States and United Kingdom are also moving in this direction following the recent economic crisis.

- In the survey, 70% of the countries (99 countries) report that central banks or bank regulators are responsible for at least some aspect of financial consumer protection.
- Of these, 68 countries assigned this work to a specific department or unit, the majority of which are relatively recent.
- Out of the 60 countries that provided their units' date of establishment, 65% were created after 1999, and 45% after 2005.

Often these departments also perform a number of other functions.

In 31 countries, consumer protection work is assigned to a financial institution supervision department.

- In Austria, Botswana, Kenya, Macedonia, and Sri Lanka consumer protection is part of routine supervisory work with no organisational separation of consumer protection tasks

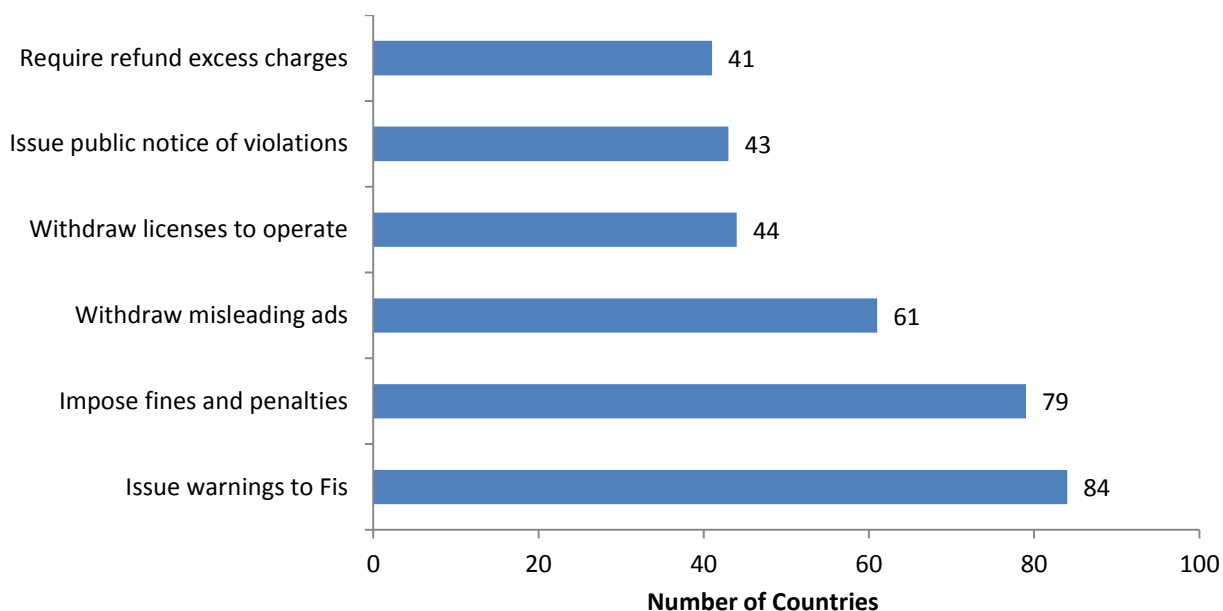
from supervision activities. Philippines, Spain, Brazil, Israel, and Zimbabwe have a dedicated team or unit within the banking supervision department that handles consumer protection.

- An alternative approach taken by 13 countries is to create a dedicated department. In Czech Republic, the Consumer Protection Department reports directly to the Board of the Czech National Bank. In Ecuador, the department reports directly to the Bank Superintendent.

### Enforcement powers available to regulators

The survey asked a number of questions on enforcement powers available to the regulators and on monitoring methods they use to ensure compliance.

The responses indicate that enforcement powers are often limited. The figure below plots the availability of different alternatives for the regulators in cases of non-compliance with consumer protection laws by the financial institutions.



**Figure 13: Trends in taking action to enforce consumer protection laws**

Source: Adapted from Policy Research Working Paper 5536

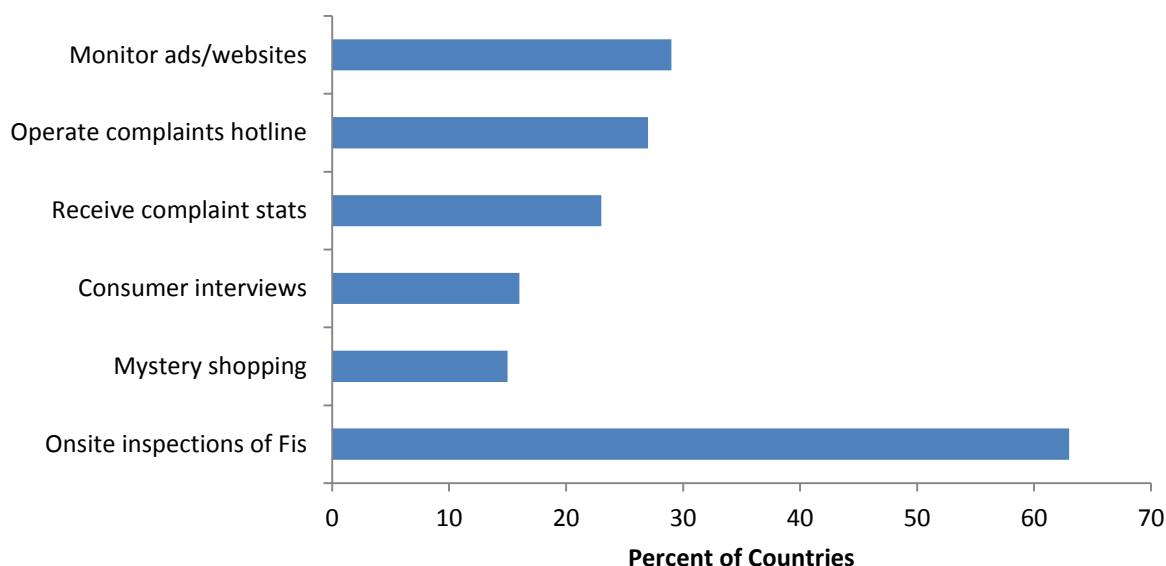
- Regulators in around 50-60% of the countries have powers to issue warnings to financial institutions or impose fines and penalties for violation of consumer protection regulations.
- About a third are empowered to issue a public notice of violation, require providers to refund excess charges or withdraw a license to operate.
- In a number of countries, even though the agency had the responsibility to monitor compliance with consumer protection regulations, the respondents stated that they were only authorised to take action if the violations posed a risk to financial stability, significantly limiting the regulator's ability to take action.

## Monitoring compliance

Monitoring compliance with financial consumer protection regulations is an essential element of effective implementation of the legislation.

- The survey responses indicate that no more than half of financial regulators monitor compliance through proactive means such as the following:
  - monitoring advertisements and websites;
  - operating complaints hotline;
  - receiving complaint statistics from financial institutions,;
  - conducting consumer interviews and focus groups; and
  - engaging in mystery/incognito shopping.

The figure below shows what agencies do to monitor compliance with consumer protection.



**Figure 14: Mechanisms agencies use to monitor compliance with consumer protection**

Source: Adapted from Policy Research Working Paper 5536

- The vast majority – 67% of those with the authority to enforce financial consumer protection monitor compliance through on-site inspections. This approach may not be sufficient to fully capture the scope and nature of the violations and direct contact with the user of services.
- Other methods mentioned above can enhance monitoring effectiveness of the responsible agency. Moreover, monitoring the trends in customer complaints can provide insights to the regulators for necessary adjustments in rules and regulations as financial products constantly evolve.

## 10.4.5 Dispute resolution mechanisms

- a lower number of countries reported the existence of a third party recourse mechanism (an important element of effective enforcement of consumer protection regulations);
- 82 countries 58% reported having these mechanisms such as the following:
  - ombudsman; or
  - mediation centre.

In financial transactions, especially those involving low-income individuals, power imbalances between providers and users of financial services are substantial. An individual is unlikely to initiate and go through a legal process when subjected to unfair treatment due to insufficient resources and/or understanding. A modern financial consumer protection framework relies on the following two key mechanisms to address this concern:

- It involves financial institutions establishing an effective mechanism to receive and resolve customer complaints.
- In case the complaint is not resolved within a reasonable time, or the customer is not satisfied with the outcome, the complaint may be referred to a third party independent dispute resolution mechanism such as an ombudsman or a mediation service.

Only around one-third of the countries in the survey report the existence of laws or regulations that set standards for internal complaint resolution mechanisms for financial institutions. These standards include:

- certain processes to be implemented;
- standards on the timely handling of complaints, and
- accessibility.

The fact that there are no clear standards on handling and processing complaints in most countries raise doubts on the ability of the supervisory agency to monitor and assess how well financial institutions manage these complaints.

- more than half of the countries in the survey 58% report having a third-party dispute resolution mechanism;
- 30% of countries have a specialised financial Ombudsman, while 21% have a general Ombudsman that handles financial consumer protection issues along with others;
- different types of third-party dispute resolution mechanisms are not mutually exclusive, and some countries have more than one type;
- mediation services tend to be more common in Asia, where about half of the countries report their existence compared to a quarter or less in other regions; and
- 57% of high-income countries have financial Ombudsmen, only 5% of low-income countries have them.

### **Funding schemes of third-party dispute resolution mechanisms**

- The funding schemes of third-party dispute resolution mechanisms vary across countries.
- In 33 countries (out of 63 where data were available), ombudsmen/mediation centres are fully funded by the government, and in 22 countries, they are fully funded by industry associations, or members (service providers).
- In 8 countries, ombudsmen are public-private partnerships co-funded by the government and the private sector.

Ombudsmen/mediation centres work on a variety of complaints:

- The most common cause of complaints that was brought forth to third-party dispute resolution mechanisms based on the data reported in the survey is excessive interest rates or fees.

- Other causes include product-related issues for insurance, mortgage/housing loans, credit cards and ATM transactions.
- In a few countries, not being approved for a loan is brought up as a complaint.

In 53 of the 82 countries where third-party dispute resolution mechanisms exist, data on the number of complaints received were available and vast differences in statistics reflect the nature of these mechanisms as well as their levels of activity. For example, third party dispute resolution mechanisms vary greatly in terms of the process for submitting complaints – in some cases restricting the types of products on which complaints can be submitted.

The number of complaints range from less than one per 1 million adults in Uzbekistan, Bulgaria and Poland (a total of 1, 5 and 9 complaints received, respectively) to 2.52 per 1 000 adults in the U.K. (127 471 complaints received) and 2.76 complaints per 1 000 adults in Portugal (24 863 complaints received).

30 countries were also able to provide data on the number of cases processed and closed as well as the number of cases resolved in favour of the consumer. In the majority of these countries, 70%, less than half of all complaints, were resolved in favour of the consumer.

These numbers also involve a large degree of cross-country variation. For example, in Singapore, only 2% of cases result in favour of the consumer, while in Venezuela, the same number is as high as 97%. Nonetheless, cross-country comparisons of this type may not be very reliable due to the large variation in existing systems and regulations and the variation in the complaint causes.

However, monitoring of complaints within a country on a regular basis provides essential information on the health of the retail finance market and can inform regulatory actions.

## 10.5 Key insights

The Financial access survey provides a number of insights such as the following:

- Most countries have some form of consumer protection legislation in place, though it often does not include provisions specific to the financial services industry.
- Enforcement powers and monitoring ability of supervisors are often limited.
- Unregulated financial institutions are rarely covered by existing financial consumer protection legislation.
- Regulations on financial consumer protections are often recent and many countries are actively reforming in this area. Reforms have increased since the beginning of the global crisis in 2008 in both developed and developing countries. For example, Madagascar and Moldova are introducing consumer protection laws. France, the US and the UK all have reform the structure of the regulatory bodies in charge of financial consumer protection.

The diffused nature of legal provisions relevant to consumer protection in financial services poses a number of challenges that include:

- Different laws may contain conflicting provisions, making compliance difficult.

- The laws may assign supervisory and regulatory powers to a number of agencies which pose a number of challenges in effectively implementing legislation. In recent years, several countries established a single agency responsible for consumer protection issues for retail financial services. Among them are the Financial Consumer Agency of Canada and the National Credit Regulator in South Africa that is solely responsible for regulation of the credit market.
- More importantly, a greater focus by regulators on monitoring compliance and collecting data on consumer complaints and on how they are resolved can help inform public policy. Regulatory impact assessments at the country level, including the impact on the users of financial services, as well as on the cost to financial institutions, are also an important component in determining the most effective approaches to ensuring fair and transparent retail financial markets.

## 10.6 Global interests in South Africa's NCA

There are widespread claims that South Africa was largely insulated against the effects of the global financial crisis due to the introduction of the NCA (2007), Basel II (2008), a conservative regulatory framework as well as conservative lending practices. The main provisions of the NCA came into effect on the 1st of June 2007.

In 2008, it was reported that Peter Setou, a senior manager at the NCR said that in the light of the global credit crunch, many African and European nations were soliciting advice from South Africa to help them with strengthening their credit policies. The NCR also received delegations from Botswana, China, Mongolia and the European Coalition for Responsible Credit (ECRC) who wanted to learn about the NCA.

On November 12, 2008, Setou travelled to London to address a 2-day conference hosted by the ECRC, a powerful coalition of non-profit organisations whose main objective is to press Western European governments to adopt legislation that encourages responsible credit granting. The NCR's global reach also took it to Brazil where its chief executive, Gabriel Davel spoke about the NCA at the 3rd Global Credit Reporting Conference.

### 10.6.1 Namibia

In particular, the NCR assisted Namibia to develop similar legislation like the NCA.

There are gaps in literature on the exact provisions of the NCA that were integrated into the Namibian legislation, if any. The Financial Access Survey of 2010 notes that Namibia has a general consumer protection law which has no explicit reference to financial services. The same survey also notes that Namibia does not have the following:

- consumer protection law with explicit reference to financial services;
- consumer protection regulations within the framework of financial sector legislation; and
- other types of consumer protection regulation.

Because of paucity of literature on exactly what Namibia has taken and adopted out of the NCA, it is difficult to quantify or determine the impact of the adopted NCA provisions on the credit market in Namibia. In the same breadth, it is difficult to qualify the challenges or likely challenges that Namibia is encountering in terms of adoption and implementation of the South African NCA model.



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## 10.6.2 Botswana

The NCR received delegations from Botswana who wanted to learn about the NCA.

There are gaps in literature on the exact provisions of the NCA that delegation from Botswana adopted and integrated into the legislation. The Financial Access Survey of 2010 notes that Botswana has the following legislation:

- a general consumer protection law without explicit reference to financial services.

The same survey also notes that Botswana has the following legislations:

- general consumer protection law without explicit reference to financial services:
  - Consumer Protection Act (1998) – the Consumer Protection Act is under the Ministry of Trade and Industry.
- consumer protection law with explicit reference to financial services:
  - Banking Act, Chapter 46:04 (1995) – the Banking Act has selected sections which cover consumer protection issues.
- consumer protection regulations within the framework of financial sector legislation:
  - Banking Act, Chapter 46:04 (1995).

As a result of lack of literature on exactly what the Botswana delegation to the NCR have taken and adopted out of the NCA, it is difficult to quantify or determine the impact of the adopted NCA provisions on the credit market in Botswana. In the view of these gaps in literature, it is also difficult to ascertain and specify the challenges or likely challenges Botswana is encountering in terms of implementation by adopting the South African NCA model.

## 11 CONCLUSIONS

In summary, what is the real impact of the NCA on the South Africa economy and what would be used as a measure to establish the impact?

There is clear consensus in all of the material researched that the NCA has added significantly to the stability of the South African economy in the 2008 credit crisis and the period that followed. General agreement says that the over-indebtedness in the country would be much higher if the NCA had not been in place.

The challenge around the above consensus is that it is based on a general understanding. None of the research has even attempted to establish to what extent the NCA changed the landscape, which is not surprising as the extra-ordinary economic events distort the picture, and benchmarking therefore becomes a theoretical exercise. What is the cause and what is the effect can be used interchangeably in different arguments. We know for instance that there was a flurry of credit granting ahead of the implementation of the NCA, which certainly off sets some of the subsequent conservatism. Whether that activity picked up significantly more risky transactions is not known.

Then there is a question that is asked, *Is it the NCA or the credit crisis that had the largest impact on credit providers becoming a lot more cautious?* The other question is around the impact of more conservative lending in causing the problems in the credit market specifically in the housing market.

We know that the 2008 re-assessment led by FNB around pre-approved bonds on properties under construction, led to the collapse of certain development projects and a drop in prices (and hence collateral value). Clearly, pre-NCA, a lot of reliance in the credit process was placed on the saleability of property, which created the opportunity for settlement by sale. So did FNB pre-empt inevitable default of the consumer, or, did they create further default in the market as they took out consumers from the process of buying and selling?

The above shows that cause and effect are not all that well defined and that the one will re-enforce the other in a circular manner.

### 11.1 Implementation of the NCA

Literature clearly shows significant engagement of all stakeholders with the NCA and the NCR as the regulator. The Act is not written in the clearest possible form and hence a lot of work and time of the legal system has gone into defining this into more detail. This has led to a large number of court cases with some defining court decisions. Industry engagement and task teams delivered a number of codes of conduct in order to facilitate the working of the Act into the system.

It is debatable whether all court decisions match the actual intention of the legislature when drafting the Act. Certain decisions have also led to a much more complex process around debt counselling, which is in conflict with the intention of that process in terms of *getting consumers back on their feet* from a financial perspective and allowing them to move on.

The NCA certainly lacks embedding in the overall legal framework. As a result, legislation around insolvency and debt collection stand on their own, and yet they are closely interlinked. The lack of consideration will inevitably impact consumers since credit providers can pursue sequestration in an attempt to stop consumers from enabling the debt review process.

There is no doubt that a lot of work in clarifying and embedding the NCA into the South African credit market has been delivered. The overall understanding is improving over time and

stakeholders are engaged around finding solutions. Mechanisms are working to deal with non-adherence by debt counsellors and credit providers.

However, the latter is dealt with on a complaints basis, so there is no pro-active detection around these matters. Furthermore, the research states that the working relationship between stakeholders also results in some of the acrimonious discussion around reckless lending being side stepped in favour of getting resolution around debt restructure.

Therefore, the question as to whether the system works and if it impacts probably can be answered positively.

However, we do not have predetermined standards to measure effectiveness against. If you look at 1 000s of case for debt restructure being stuck in the court systems, and more than half of the credit consumers on record that cannot pay their debts, it is difficult to deem the impact successful (enough).

In the last 5 years, numerous issues have been raised around the legislation, which the legislature should clarify and in most instances simplify. As proper industry frameworks exist, more weighting could be given to self-regulation via the codes of conduct and the necessary regulatory basis for oversight on these to be established.

There has to be full engagement of the industry and the legal system around *how to clear the backlog* of debt review/restructure cases. The first step has to be to map out all the avenues a consumer could follow, because they can easily get lost in the myriad of options for different challenges around credit agreements. Alternate debt resolution should be advocated as a first choice and not debt review. Our research has shown that no one has published that road map to the consumer. This should be done as a matter of priority.

The fact that the Ombud did adjudicate 600 cases of reckless lending means that there may be an alternate avenue for resolution on non-debt review related credit matters.

The role of the NCT has become unclear to the consumer given the court decision on referral of all debt review matters to the Magistrates Court. That avenue should be re-opened to handle consent orders.

Task and target should be driven in terms of enabling our consumers to reset their debt situation and move onto a scenario where debt is being serviced.

## 11.2 Access to credit and to the remedies of the NCA

The question as to whether or not access has been extended to the part of the market referred to as previously disadvantaged is to a greater extent unanswered. There has been some inroads made by the formal lending institutions, and the growth in credit consumers does seem to indicate growth.

The recurring theme in most services seems to be that consumers with limited means are not attractive customers. Even with the higher rates allowed under the NCA, micro loans are not easily turned into a viable business proposition. Loan sharks are clearly still viable as there is a price (outside the NCA parameters) at which they enter the market place and fill the gap.

Debt counsellors indicate that consumers with little ability to repay are not viable clients for them from return on effort point of view. It is further noted that on small monthly repayments, the cost of the Payment Distribution Agency becomes disproportionate and hence it no longer makes sense to follow this route.

The current statistics gathered, reliably obtained from the formal sector, state banks as dominant parties in the credit market. Smaller providers may not report and therefore skew the picture somewhat. Developmental lending is happening in a very limited manner and based on the returns from the banks, not done by them (unless it is rolled up in other numbers and hence becomes invisible).

Legislation in combination with market forces is not delivering growth here, and if it is, it is not clearly benchmarked. Research does not give matters clear direction either, in this particular field.

The recommendations would be to establish a research framework that would set up measurements to be obtained, and then be done each year on a similar basis to ensure that trend analysis starts becoming a possibility in this field. Time should be spent on the design before rushing off to collect data and redesign against next year. We have seen in most of the surveys on Financial Access that consistency in research questions and methodology across the years is missing. Therefore, it is difficult to draw any conclusions from these.

Rolling this segment from a legislative point of view in the same framework will allow for similar consumer protection, but is unlikely to stimulate access. It is ideas like a fidelity fund for debt counselling cost for these consumers that have a better chance of success. In terms of the formal research, there is some indication from credit providers that high caps may entice them into these markets. However, it is risky to simply increase caps and leave it to market forces as that may just lead to the current consumer paying more without access being extended. Target setting into a specific space would have to become part of this.

Much has been written about co-operative banks, credit unions etc. To facilitate financial access, further support from a political perspective to develop these may have a more significant impact on broadening access than NCA legislation.

## 11.3 Reckless credit

At face value, the *reckless lending* provisions seem a very powerful tool of the NCA in terms of preventing consumers from getting into too much credit in the first place. The sanction for the credit provider is quite steep as reckless agreements could be set aside completely and become unrecoverable, hence it should deter this practice. However, disclosure by the client is the key defence here, and there seems to be little obligation on the credit provider to verify information. Staff at the credit providers just go through the motions in order to have on record (i.e. are able to prove) that the affordability is there. They do not query the often times quite blatant understatement of expenses by consumers applying for credit.

There is therefore need for guidelines to establish a more realistic expenditure pattern as a pro forma to be used in the credit assessment process. Views diverge as to how easy or not it is to establish this and there is undoubted complexity since backgrounds and lifestyles are not homogenous per LSM. However, trends could be identified and as a starting point, and better questionnaires should be developed for use during the credit application process which prompts closer scrutiny and provides more room for verification.

In most literature, credit providers give the defence that *affordability was there on paper*, as evidenced by a signature from the consumer. This removes all responsibility on their side around ensuring that their lending was not reckless. Furthermore, once the credit is in place and repayment problems start surfacing, we find the recourse to reckless lending claims to be rather limiting. Debt counsellors report that they have tried and have failed pursuing this route for consumers and hence they pretty much see this as a closed door for recourse. Given the dependency of the debt counsellor on his good relationship with credit providers, the debt counsellor is likely to avoid the acrimonious *fight* around proving reckless lending.

Access to the remedy of the NCA will have to be safe-guarded and the correct routes for adjudication need to be established. It seems the Ombud may have a greater role to play in this.

Secondly, standards have to be developed to aid the credit granting process. This starts at setting out norms for expenditures across the LSMs to make informed decisions and validate the consumer information to ensure credit is not granted based on unrealistic details provided by the consumer.

## 11.4 Shopping around for the best deal not that easy

Practice seems to be that quite often quotations are not available. For instance, with card products, they are produced with the card, and consumers tend to just sign it as a formality when they collect the card from the credit provider. Quotes are not that easy to understand and often difficult to compare, hence more prescriptive guidelines are required to ensure a level of standardisation which allows for comparison. There should be guidelines that include rules around fonts, as it is noted that quite often the pertinent information like instalments is printed in a smaller font. Interesting enough, shopping around is not necessarily without challenges because having multiple credit enquiries on your credit profile also raises concerns with credit providers about other debt being taken up simultaneously which may actually lead to declines. Additional costs like credit life insurance add significantly to the cost of credit, which is not necessarily explained in the upfront sales conversation. Furthermore, the cost of default, i.e. the charges for late or non-payment is not clearly outlined, and certainly not well understood at the time of entering into the agreement.

Standardisation and consumer education will be required to give this more effect. One of the suggestions raised which may be useful is posting model quotes on the wall of credit providers. However, firstly, an industry standard will have to be designed and agreed through the necessary stakeholder forums.

## 11.5 Cost of credit versus access of credit

There are clearly opposing forces at play. So the one side of the argument which is raised by the credit provider constituency is that restrictions on cost mean that very few consumers get access to credit. A number of reasons are given. One is that, it has to be profitable to operate in a certain market, or location. Their revenue needs to be commensurate with the investment in order to unlock that market. If markets are not viable within the legal constraints on pricing, those markets that are not being serviced are left vulnerable to the (re-)emergency, or growth of the loan sharking businesses.

Secondly, credit pricing is based on the *price for risk* concept, so if the regulations limit the amount that can be charged, by implication, this means that the higher risk consumer will not have access to credit.

Thirdly, the argument that is being raised is that continued uncertainty around NCA interpretations and delays in enforcement of loan agreements, and the realisation of collateral is negatively impacting the expected recovery under a loan agreement, in case of default. This raises the overall price of credit to the full consumer base. The expected loss on the overall loan book of a credit provider is priced into each individual loan granted.

So what is the other side of the argument, which is mainly the consumer protection aspect which looks at the cost to the consumer and the social impact of this equation?

The NCA clearly is preventing usurious interest rates from being charged. It limits the fees payable and hence keeps the loans ultimately at a level of affordability. Based on the issue that is emerging around the high premiums for embedded credit life insurance (which is used to supplement the credit providers' income), one might say that more laws should be put in place to prevent this more indirect loading of the cost of credit.

Then, there is the question as to whether or not there should be growth in credit granting into more high risk territories. Let us consider the following statistics. As at the end of December 2010, credit bureaus had records for 18.51 million credit-active consumers:

- Of the 18.51 million credit-active consumers, 53.5% (9.90m) were classified as being in good standing.
- The number of consumers with impaired records increased to 8.61m in this quarter. This indicates a deterioration in the credit records of 120 000 consumers quarter-on-quarter and 426 000 year-on-year.

This is a pretty bleak picture of where the overall credit market is at, at the moment. In terms of the objectives of the NCA, and generally, from a consumer or economic perspective, any growth in this level of impairment is bad news. If one were to increase pricing caps to encourage credit providers into more high risk territory, this is likely to increase the level of impairments because when credit providers price for the higher level of default, they are also likely to incur higher levels of default.

Whilst the theoretical argument around access markets is correct, it is not clear from the research what exactly the impact is in practice. It seems that in the micro lending space, they may have experienced a pull back, or, a business failure of small micro lending businesses, which used to provide credit but now is no longer profitable enough, especially in light of the relatively small loan sizes in this market. It is however unclear to what extent banks have pulled out of these areas due to credit pricing. For a bank branch to be viable, much more than just the lending margins will be considered.

Another point that is raised is the fact that the mortgage lending market has declined quite significantly since 2008 and has continued to do so due to the strong emergence of unsecured lending in the banking environment. Mortgage lending however, has been priced well within the caps. Research shows that banks, who are the main providers of this type of credit, are not pushing for the increase of interest rate caps strongly. They are more outspoken regarding fee levels being adjusted upwards, but they do not raise this as a main disabler.

So the challenge here is that there are opposing forces at play, and increasing pricing caps may stimulate the market but also, simultaneously increase the level of default. So, one objective is that one requires a stimulation of the market to the appropriate extent by controlling the pricing caps, but the other objective requires one to consider the impact on the debt levels in the country. There is a need to broaden the access, but also one needs to limit the growth of further defaulting levels.

It is not something for which anyone can present a model that will provide the answer. Research can indicate in which direction each of the decisions it is expected to impact, but not to what extent. There is no mathematical equation to predict that. Hence ultimately, whatever is decided around this will be a judgment call. If certain consequences of a change are desirable, and provided the trend indicates movement in that direction, it may be worthwhile to make conditional changes rather than leaving it to market forces.



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## 11.6 Consumer behaviour

Quite a large number of research and media articles talk about the consumer as a less than innocent bystander in financial crisis and in need of debt review. Cases for reckless lending are being turned down by Ombud or the court because the consumer actually did not disclose all the necessary information they when applying for credit. It is a known fact that the South African consumer does have a tendency to take out credit for consumption (rather than asset/business building purposes), and repayment discipline may not always be what it should be.

The argument that consumer legislation takes away the consumer's own sense of responsibility and encourages irresponsible behavior however, is contentious. In South Africa, there is a need for consumer legislation to be robust. Given the high level of illiteracy and financial illiteracy, the importance of protecting those vulnerable consumers is undisputable.

## 12 ANNEXURE 1: CREDIT MARKET IN INDIA

### 12.1 Introduction

This analysis below provides a comparative analysis of the National Credit Act (NCA) regulatory regime with other countries of similar economic structure and system. Much of the analysis dwells on India, considering that India is one of the **BRICS** countries, just as much as South Africa (inclusion in 2010). **BRICS** is a grouping acronym that refers to the countries of Brazil, Russia, India, China and South Africa which are all deemed to be at a similar stage of the newly advanced economic development. Much of the analysis on the Indian credit market has been taken directly from the May 2007 Reserve Bank of India publication report.

The second part of the comparative analysis looks at various countries with respect to regulatory regimes with a view to provide an overview of the credit market regulatory framework in different countries.

### 12.2 Contextualisation

In order to contextualise the comparative analysis, it is important to provide a background of the Indian credit market regulatory regime and the South African credit market regulatory regime, i.e. the NCA.

Credit markets have historically played a crucial role in sustaining growth in almost all countries, including advanced countries, which now have fully developed capital markets. Credit markets perform the critical function of intermediation of funds between savers and investors, and improve the allocation efficiency of resources. Banks, which are the major players in the credit market, play an important role in providing various financial services and products, including hedging of risks. Credit markets also play a key role in the monetary transmission mechanism.

### 12.3 Credit risk

Extension of credit poses some risks, which range from pure credit risk to the risk of over-lending. Pure credit risk is the risk of loss due to non-payment by the borrower, even though adequate precautions are taken at the time of loan origination. The risk of over-lending arises when banks extend loans without appropriate credit appraisal and due diligence on account of excessive optimism about future prospects. While pure credit risk may not be widespread and may normally not create systemic problems, over-lending is unsustainable and potentially destabilising for the system. Regulators in all countries therefore, while seeking to maintain adequate growth, guard against its adverse impact by instituting appropriate regulatory and supervisory policies and strengthening of prudential norms.

### 12.4 Regulatory framework in South Africa: The main tenets of the NCA

The main aim of this section is to provide an overview of the measures in the NCA directly aimed at the following:

- rules around credit granting (specific focus on the prevention of reckless lending to consumers;
- rules around capping of interest or fees to be charged;
- rules around management of debt relief when consumers get into financial difficulty and are unable to settle debt;
- development component (i.e. legislation to promote access to finance for a broader part of the population and the role played by financial literacy and legislation impacting this).

### **12.4.1 Rules around credit granting**

The NCA provides measures to combat reckless credit lending and over indebtedness. Section 81 compels a credit provider to first of all do a 3 part assessment before entering into a credit agreement with a consumer.

Reasonable steps have to be taken to determine the proposed consumer's general understanding and appreciation of the risks and costs of the proposed credit, as well as of the rights and the obligations of a consumer under a credit agreement. In terms of the second part of the assessment, regard must be made to the proposed consumer's debt re-payment history under credit agreements. Thirdly, the proposed consumer's existing financial means, prospects and obligations have to be assessed.

### **12.4.2 Rules around capping of interest**

The NCA restricts credit providers with regard to the maximum interest rates that may be imposed. The Act regulates interest rates by specifying maximum interest rates that credit providers charge consumers for various credit agreements.

### **12.4.3 Rules around management of debt**

The Act provides for consumers who are unable to service their monthly repayments on their credit agreements to be assisted by debt counsellors to arrange their credit providers.

### **12.4.4 Rules around development component**

The NCA strives to promote the development of a credit market that is accessible to all South Africans, and in particular to those who have historically been unable to access credit. The Act has measures that ensure that every person, whether an individual, a group of people, or, a company, has the right to apply for credit from any credit provider. Consumers who are applying for credit are further protected against unfair discrimination by a credit provider. The Act forbids credit providers from discriminating against consumers on the basis of colour, race, age, political affiliation, sexual orientation, religious belief, or affiliation to any particular trade union.

In addition to broad based financial inclusion, the NCA provides for measures regarding financial literacy, i.e. education of consumers concerning credit matters. The Act is aimed at correcting the imbalances in the negotiating power between consumers and credit providers by providing consumers with education about credit and consumer rights. Consumer education as provision of the Act is the mandate of the NCR. The NCA states that the NCR is responsible for increasing knowledge of the nature and dynamics of the consumer credit market and industry. It is also the task of the NCR to promote public awareness of consumer credit matters by implementing education and information measures to develop public awareness of the Act's provisions.

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## 12.5 Credit market in India

The credit market in India has traditionally played a dominant role in meeting the financial needs of various segments of the economy. Credit institutions range from well-developed and large sized commercial banks, to development finance institutions (DFIs), to localised tiny co-operatives. They provide a variety of credit facilities such as:

- short-term working loans to corporates;
- medium and long-term loans for financing large infrastructure projects; and
- retail loans for various purposes.

Unlike other segments of the financial market, the credit market is well spread throughout the country and it touches the lives of all segments of the population.

Prior to initiation of financial sector reforms in the early 1990s, the credit market in India was tightly regulated. Bank credit was the principal focus of monetary policy under the credit planning approach adopted in 1967-68. In the absence of a formal intermediate target, bank credit aggregate as well as sectorial, came to serve as a proximate target of monetary policy. Monetary policy up to the mid-1980s was predominantly conducted through direct instruments with credit budgets for banks being framed in sync with monetary budgeting (Mohan, 2006a).

The credit market was characterised by credit controls and directed lending. Various credit controls existed in the form of:

- sectorial limits on lending;
- limits on borrowings by individuals;
- stipulation of margin requirements;
- need for prior approval from the Reserve Bank – if borrowing exceeded a specified limit (under the Credit Authorisation Scheme); and
- selective credit controls in the case of sensitive commodities.

Lending interest rates by all types of credit institutions were administered. Credit markets were also strictly segmented. While commercial banks catered largely for the short-term working capital requirements of industry, development finance institutions focused mainly on long-term finance. Competition in the credit market was also limited. This led to several inefficiencies in the credit market.

A wide range of regulatory reforms were therefore introduced as part of the financial sector reforms in the early 1990s to improve the efficiency of the credit market. As a result, the credit market in India has undergone structural transformation. The credit market has become highly competitive even though the number of credit institutions has reduced due to merger/conversion of 2 DFIs into banks, weeding out of unsound non-banking financial institutions (NBFCs) and restructuring of urban co-operative banks (UCBs) and regional rural banks (RRBs). Credit institutions now offer a wide range of products. They are also free to price them depending on their risk perception.

## 12.6 Significance of credit market

There is a broad consensus, among both academics and policy makers, that a developed financial system spurs economic growth through a number of channels which include:

- acquisition of information on firms;
- intensity with which creditors exert corporate control;
- provision of risk-reducing arrangements;
- pooling of capital; and

- ease of making transactions (Levine, 2004).

There are 2 mechanisms for mobilising savings and channelling them into investments, i.e. bank-based and market based. Empirical evidence reveals that while a more developed financial sector is associated with higher income levels, there is no clear pattern with regard to financial structure.

In most countries, both the systems exist even though one system may be more dominant than the other. However, of the 2 systems, credit institutions have the distinct advantage in information gathering and processing to monitor the efficiency and productivity of projects. In fact, in recent years, the existence of banks which are the major players in the credit market is attributed more to their information gathering capacity arising out of the existence of asymmetric information and moral hazard problems, than to the classic explanation relating to their ability to mobilise savings and channelling them into investment. Savers usually have incomplete information on the affairs of companies, which makes it more difficult for companies to obtain direct financing from the market. Intermediation by banks mitigates such agency problems.

When the cost of acquiring information on a company by the providers of financial resources is high, the process of financing companies can be done more efficiently if the prospective investors are able to delegate the collection of such information to a specialised organisation (Diamond, 1984). Thus, financial intermediation is justified on the grounds of information gathering and company monitoring functions performed by banks. By reducing the costs of acquiring and processing information, financial institutions encourage mobilisation of savings and improve resource allocation. Banks can also diversify risk among a number of companies.

Firms in developing countries generally tend to rely more on debt finance, including bank credit. The emphasis on credit rather than equity arises due to various reasons. The cost of equity in developing economies is often much higher than the cost of debt due to the existence of higher perceived risk than in developed countries. The existence of artificially repressed interest rates contributes further to the problem. The other reasons for the heavy reliance on debt in developing countries include:

- the fragility of their equity markets;
- lack of suitable accounting practices; and
- the absence of adequate corporate governance practices.

Given the high dependence on bank credit and lack of substitutes for external finance, firms in developing economies are generally highly sensitive to changes in the cost and flow of credit.

Credit markets in developing countries in particular play an important role, where apart from industry; agriculture is also an important segment of the economy. Besides, there are also a large number of small and medium enterprises in the industrial and service sectors which are not able to access the capital market and have to depend on the credit market for their funding requirements. Thus, the importance of banks and other lending institutions in developing countries can hardly be overemphasised.

Development of the credit market plays an important role in the monetary transmission mechanism. The traditional interest rate channel, represented by the *money view*, mainly focuses on the liability side since banks create money through cheque deposits. The asset side is not emphasised as firms' financial structure is believed to be neutral to borrowings through loans from banks or through issuance of securities. This is based on the assumption that different financial assets such as bonds and bank loans are perfect substitutes. However, in terms of *credit view*, bonds and bank loans are not seen as perfect substitutes primarily because of information asymmetries. Firms facing informational problems find it more expensive to borrow through bonds than availing loans from banks.

Given that a developed financial intermediation system facilitates growth, policy makers tend to liberalise the system to facilitate financial development. Literature available however, suggests that authorities should take adequate caution in adopting a liberalised policy framework that is intended to develop the financial sector (IMF, 2006). Lax supervision and rudimentary regulation of newly liberalised financial institutions, often combined with a volatile macroeconomic environment, have led to systemic crises (Lindgren, *et al*, 1996 and Caprio and Klingebiel, 2003). Similarly, there is econometric evidence that shows that banking crises are more likely to occur in countries associated with liberalised credit markets operating in weak institutional environments. The East Asian crisis underlined the risks to economic stability and growth that a weak or vulnerable financial sector could pose.

## 12.7 Institutional structure of the Indian credit market

The credit market structure in India has evolved over the years. A wide range of financial institutions exist in the country to provide credit to various sectors of the economy. These include:

- commercial banks;
- regional rural banks (RRBs);
- cooperatives [comprising urban cooperative banks UCBs];
- state co-operative banks (STCBs);
- district central co-operative banks (DCCBs);
- primary agricultural credit societies (PACS);
- state co-operatives and agricultural rural development banks (SCARDBs);
- primary co-operative and agricultural rural development banks (PCARDBs)];
- financial institutions (FI) (term-lending institutions, both at the centre and state level, and refinance institutions); and
- nonbanking financial companies (NBFCs).

Scheduled commercial banks constitute the predominant segment of the credit market in India. All in all, 83 scheduled commercial banks were in operation at end-March 2006. The commercial banking sector is undergoing a phase of consolidation. There have been 12 mergers/amalgamations since 1999. The RRBs, which were set up in the 1970s to provide agricultural and rural credit, are being restructured as an initiative of the government of India. Till October 31, 2006, 137 RRBs were amalgamated to form 43 new RRBs, bringing down the total number of RRBs in the country to 102 from 196 at end-March 2005.

The co-operative banking system with 2 broad segments of urban and rural co-operatives forms an integral part of the Indian financial system. Urban cooperative banks also referred to as primary cooperative banks, play an important role in meeting the growing credit needs of urban and semi-urban areas of the country. The UCBs, which grew rapidly in the early 1990s, showed certain weaknesses arising out of the lack of sound corporate governance, unethical lending, comparatively high levels of non-performing loans and their inability to operate in a liberalised environment. Accordingly, some of the weak UCBs have been either liquidated, or merged with other banks. As a result, the number of UCBs declined from 1 942 at end-March 2001 to 1 853 by end-March 2006.

Historically, rural co-operative credit institutions have played an important role in providing institutional credit to the agricultural and rural sectors. These credit institutions, based on the nature of their lending operations, have typically been divided into 2 distinct segments, commonly known as the short-term cooperative credit structure (STCCS) and the long-term co-operative credit structure (LTCCS). The STCCS comprising PACS at the village level, DCCBs at the



intermediate level, and the STCBs at the apex level, provide crop and other working capital loans to farmers and rural artisans primarily for short-term purposes.

The LTCCS, comprising SCARDBs at the state level and PCARDBs at the district or block level, provide typically medium and long-term loans for making investments in agriculture, rural industries and, in the recent period, housing. However, the structure of rural co-operative banks is not uniform across all the states of the country. Some states have a unitary structure with the state level banks operating through their own branches, while others have a mixed structure incorporating both unitary and federal systems.

Financial institutions owed their origin to the objective of state driven planned economic development, when the capital markets were relatively underdeveloped and judged to be incapable of meeting adequately the long-term requirements of the economy. Over the years, a wide range of FIs, mostly government owned, came into existence to cater for the medium to long-term financing requirements of different sectors of the economy. FIs played a key role in extending development finance in India, and for this purpose, they were given access to concessional finance in the form of government guaranteed bonds and long-term operations fund of the Reserve Bank.

However, the government's fiscal imperatives and market dynamics forced a reappraisal of the policies and strategy with regard to the role of FIs in the economy and the concessional finance was phased out by the mid-1990s. A major restructuring in the financial sector occurred when two major FIs, viz., ICICI and IDBI converted into banks. Thus, this particular segment of the credit market has shrunk significantly in recent years.

NBFCs encompass a heterogeneous group of intermediaries and provide a whole range of financial services. Though heterogeneous, NBFCs can be broadly classified into 3 categories, viz., asset finance companies (such as equipment leasing and hire purchase), loan companies and investment companies. A separate category of NBFCs, called the residuary non-banking companies (RNBCs), also exists and it has not been categorised into any 1 of the above referred three categories. Besides, there are miscellaneous non-banking companies (Chit Fund), mutual benefit financial companies (*Nidhis* and unnotified *Nidhis*) and housing finance companies.

The number of NBFCs operating in the country was 51 929 in 1996. Following the amendments to the provisions contained in Chapter III-B and Chapter IIIC of the Reserve Bank of India Act, NBFCs both, deposit taking and non-deposit taking, are required to compulsorily register with the Reserve Bank. One of the conditions for registration for NBFCs was a minimum net owned fund (NOF) of Rs.25 lakh at the entry point. This limit was subsequently enhanced to Rs.2 crore for new NBFCs seeking grant of certificate of registration on, or, after April 21, 1999.

A crore abbreviated cr; is a unit in the South Asian numbering system equal to 10 million (10 000 000) or 100 lakhs. It is widely used in India, Bangladesh, Nepal and Pakistan.

The Reserve Bank received 38 244 applications for grant of certificate of registration (CoR) as NBFCs till end- March 2006. Of these, the Reserve Bank approved 13 141 applications, including 423 applications of companies authorised to accept/hold public deposits. Due to consolidation in the sector, the number of NBFCs declined to 13 014 by end-June 2006.

## 12.8 Policy developments in the credit market in India

The credit market, with commercial banks as its predominant segment, has been the major source for meeting the finance requirements in the economy, both for the private sector and the central and state government enterprises. In addition to sharing of resources between the private and the public sectors, a significant proportion of credit by commercial banks is earmarked for the

priority sector<sup>1</sup>. For a few decades preceding the onset of banking and financial sector reforms in India, credit institutions operated in an environment that was heavily regulated and characterised by barriers to entry, which protected them against competition.

The issue of allocation of bank resources among various sectors was addressed through mechanisms such as SLR, credit authorisation scheme (CAS), fixation of maximum permissible bank finance (MPBF) and selective credit controls. This regulated environment set in complacency in the manner in which credit institutions operated and responded to the customer needs. The interest rate played a very limited role as the equilibrating mechanism between demand and supply of resources. The resource allocation process was deficient, which manifested itself in poor asset quality. They also lacked operational flexibility and functional autonomy.

As part of financial sector reforms in the early 1990s, wide ranging reforms were introduced in the credit market with a view to making the credit institutions more efficient and healthy. The reform process initially focused on commercial banks. After significant progress was made to transform commercial banks into sound institutions, the reform process was extended to encompass other segments of the credit market. *As part of the reform process, the strategy shifted from micro-management to macro level management of the credit market. These measures created a conducive environment for banks and other credit institutions to provide adequate and timely finance to different sectors of the economy by appropriately pricing their loan products on the basis of the risk profile of the borrowers.*

Lending interest rates were deregulated with a view to achieving better price discovery and efficient resource allocation. This resulted in growing sensitivity of credit to interest rates and enabled the Reserve Bank to employ market based instruments of monetary control. The Statutory Liquidity Ratio (SLR) has been gradually reduced to 25%.

The Cash Reserve Ratio (CRR) was reduced from its peak level of 15.0% maintained during 1989 to 1992 to 4.5% of Net Demand and Time Liabilities (NDTL) in June 2003. The reduction in statutory redemptions has significantly augmented the lendable resources of banks. Although the Reserve Bank continues to pursue its medium-term objective of reducing the CRR, in recent years, on a review of macroeconomic and monetary conditions, the CRR has been revised upwards in phases to 6.5%.

While the stipulation for lending to the priority sector has been retained, its scope and definition have been fine-tuned by including new items. Further restrictions on banks' lending for project finance activity and for personal loans were gradually removed in order to enable banks to operate in a flexible manner in the credit market. As part of the financial sector reforms, the regulatory norms with respect to capital adequacy, income recognition, asset classification and provisioning have been progressively aligned with international best practices. *These measures have enhanced transparency of the balance sheets of banks and infused accountability in their functioning. Accounting standards and disclosure norms were also strengthened with a view to improving governance and bringing them in alignment with international norms.*

As part of the reform programme, due consideration has been given to diversification of ownership of banking institutions for greater market accountability and improved efficiency. Accordingly, several public sector banks expanded their capital base by accessing the capital market, which diluted government ownership. To provide banks with additional options for raising capital funds with a view to enabling smooth transition to Basel II, the Reserve Bank in January 2006, allowed banks to augment their capital funds by issue of additional instruments.

## 12.9 Rules around credit granting (prevention of reckless lending to consumers)

Comprehensive credit information, which provides details pertaining to credit facilities already availed of by a borrower as well as his repayment track record, is critical for the smooth operations of the credit market. *Lack of credit history is an important factor affecting the credit flow to relatively less creditworthy borrowers. In the absence of credit history, pricing of credit can be arbitrary, the perceived credit risk can be higher, and there can be adverse selection and moral hazard.*

Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced. In order to facilitate the sharing of information relating to credit matters, a **Credit Information Bureau (India) Limited (CIBIL)** was set up in 2000 (Box 1)

### Box 1: Credit Information Bureau

Credit bureaus (or credit reference agencies) are useful as they help lenders to assess credit worthiness of individual borrowers and their ability to pay back a loan. As credit bureaus collect and collate personal financial data on individuals from financial institutions, a form of price discrimination can be modelled, taking into account credit rating and past behaviour of borrowers. The information is generally aggregated and made available on request to contributing companies for the purposes of credit assessment and credit scoring.

Establishment of credit information bureaus can facilitate in obtaining the credit history of the borrowers and, thus, help the banks in correctly assessing the creditworthiness.

The CIBIL provides a vital service which allows its members to make informed, objective and faster credit decisions. CIBIL's aim is to fulfil the need of credit granting institutions for comprehensive credit information by collecting, collating and disseminating credit information pertaining to both commercial and consumer borrowers, to a closed user group of members. Banks, financial institutions, non-banking financial companies, housing finance companies and credit card companies use CIBIL's services.

Data sharing is based on the principle of reciprocity, which means that only members who have submitted all their credit data, may access Credit Information Reports from CIBIL.

With a view to strengthening the legal mechanism and facilitating credit information companies to collect process and share credit information on borrowers of banks/FIs, a draft Credit Information Companies (Regulation) bill was passed in May 2005 and notified in June 2005. The Government and the Reserve Bank have framed rules and regulations for implementation of the Act, with specific provisions for protecting individual borrower's rights and obligations.

The rules and regulations were notified on December 14, 2006. In terms of the provisions of the Act, after obtaining the certificate of registration from the Reserve Bank to commence/carry on business of credit information companies will be able to collect all types of credit information positive as well as negative) from their member credit institutions and disseminate the same in the form of credit reports to the specified users/individuals.

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## **12.10 Rules relating to priority sectors, microfinance and credit cards in rural areas**

Prior to the nationalisation of banks in 1969, banks' lending was confined primarily to big business and trading in the metropolitan and urban centres. After the nationalisation of banks, the government of India undertook corrective measures to rectify the lopsided lending by banks.

Accordingly, in 1972, banks were advised to extend credit to certain activities, known as the priority sectors. With a view to aligning bank credit to the changing needs of society, the scope and definition of the priority sector have been continuously fined-tuned by including new items as also by enhancing credit limit of the constituent subsectors (Box 2).

## Box 2: Policies relating to the priority sector, micro finance and credit cards in rural areas

### Priority sector:

- Domestic scheduled commercial banks and foreign banks are required to extend a minimum of 40% and 32% respectively, of their net bank credit (NBC) to the priority sector with sub-targets set for lending to various sub-sectors. Major categories of priority sector credit include agriculture and allied activities, small scale industries, housing loans and education loans, among others. The scope of the priority sector has been expanded over the years to include export activity, education, housing, software industry, venture capital, leasing and hire purchase.

### Micro finance:

- The SHG-bank linkage programme, launched in India in 1992 as a pilot project, envisages:
  - organising the rural poor into Self-help Groups (SHGs);
  - building their capacities to manage their own finances; and
  - then negotiating bank credit on commercial terms.
- The target-group broadly comprises small and marginal farmers, landless agricultural and non-agricultural labourers, artisans and craftsmen, and other rural poor engaged in small businesses such as vending and hawking.
- There are 2 major models under micro-finance, namely, Self-Help Group-Bank Linkage (SHG-BL) and Micro-Finance Institutions (MFIs).

### Kisan Credit Card:

- The *Kisan Credit Card* (KCC) scheme, introduced in August 1998, enables farmers to purchase agricultural inputs and draw cash for their production needs.
- The Scheme was revised in November 2004 to cover term credit as well as working capital for agriculture and allied activities, in addition to short-term credit limits available separately for crop/s.
- Short-term credit/crop loans as well as working capital for agriculture and allied activities are repayable in 12 months, while term loans are repayable within a maximum period of 5 years, depending on the type of activity/investment.
- The Scheme is being implemented by all commercial banks, RRBs, state co-operative banks/DCCBs/PACS and scheduled primary co-operative banks.

### General credit card:

- The guidelines on general credit cards (GCC) were issued on December 27, 2005, with a view to providing easy credit to banks' customers in rural areas.
- The objective of the GCC scheme is to provide hasslefree credit to the customers of banks based on the assessment of cash flow without insistence on security, purpose or end-use of the credit. This is in the nature of overdraft or cash-credit with no end-use stipulations.
- GCC may not necessarily be in the form of a card and can be issued in the form of a Pass Book, if the holder of GCC desires to operate cash withdrawals from bank branch.
- The credit facility extended under the scheme is in the nature of revolving credit. The GCC holder is entitled to draw cash up to the limit sanctioned from the specified branch of the bank.
- Banks have the flexibility to fix the limit on GCC based on the assessment of income and cash flow of the entire household. However, total credit facility under GCC for an individual should not exceed Rs.25 000 and interest rate on the facility may be charged, as considered appropriate and reasonable.
- Banks may utilise the services of local post offices, schools, primary health centres, local government functionaries, farmers' association/club, well-established community-based agencies and civil society organisations for sourcing of borrowers for issuing GCC.
- To incentivise the banks to issue GCC, 50% of credit outstanding under GCC, up to Rs.25 000, is eligible for being treated as indirect agricultural financing for the purpose of priority sector target.

## 12.11 Impact of the policy relating to the priority sector, micro finance and credit cards in rural areas

- Credit growth to the priority sector showed a distinct improvement in recent years growing at an average annual rate of 25.7% during the period from 2000–01 to 2005–06 as compared with 13.1% during the 1990s. This was mainly due to increased lending to certain sectors such as agriculture and housing.

Despite this increase, priority sector advances declined from 40.1% of non-food gross bank credit (NFGBC) at end-March 1990 to 36.3% by end-March 2006 (Table 1). With higher credit growth during 2004–05 and 2005–06 by both the public and the private sector banks, the priority sector credit target of 40.0% of net bank credit (NBC) was achieved by end March 2006.

**Table 10: Trends in outstanding priority sector advances**

(Amount in Rs.crore)

End March	Total Priority Sector Advances			Agriculture Advances			SSI Advances		
	Amount	Annual growth (percent)	Percent of NFGBC	Amount	Annual growth (percent)	Percent of NFGBC	Amount	Annual growth (percent)	Percent of NFGBC
1	2	3	4	5	6	7	8	9	10
1990	40.383	18.0	40.1	16.526	18.5	16.4	15.543	18.3	15.4
1991	42.915	6.3	37.8	16.750	1.4	14.8	17.181	10.5	15.1
1992	45.425	5.8	37.4	18.157	8.4	15.0	18.150	5.6	15.0
1993	49.832	9.7	35.5	19.963	9.9	14.2	20.026	10.3	14.3
1994	53.880	8.1	36.9	21.208	6.2	14.5	22.617	12.9	15.5
1995	64.161	19.1	34.7	23.983	13.1	13.0	27.638	22.2	15.0
1996	73.329	14.3	33.0	27.044	12.8	12.2	31.884	15.4	14.4
1997	84.880	15.8	33.8	31.442	16.3	12.5	35.944	12.7	14.3
1998	99.507	17.2	34.6	34.869	10.9	12.1	43.508	21.0	15.1
1999	1.14.611	15.2	35.2	39.634	13.7	12.2	48.483	11.4	14.9
2000	1.31.827	15.0	35.1	44.381	12.0	11.8	52.814	8.9	14.1
2001	1.54.414	17.1	36.0	51.922	17.0	12.1	56.002	6.0	13.0
2002	1.75.259	13.5	36.3	60.761	17.0	12.6	57.199	2.1	11.8
2003	2.11.609	20.7	34.1	73.518	21.0	11.9	60.394	5.6	9.7
2004	2.63.834	24.7	36.2	90.541	23.2	12.4	65.855	9.0	9.0
2005	3.81.476	44.6	38.2	1.25.250	38.3	12.5	74.588	13.3	7.5
2006	5.09.910	33.7	36.3	1.72.292	37.6	12.3	90.239	21.0	6.4
							Average annual growth (percent)		
1990 to 2000		13.1			11.2			13.6	
2001 to 2006		25.7			25.7			9.5	

**NFGBC:** Non-food gross bank credit

**Cröre:** is a unit in the South Asian numbering system equal to 10 million (10 000000).

**Source:** Handbook of statistics of the Indian economy, 2005-06, Reserve Bank of India

- Within the priority sector, credit to agriculture which grew at an average annual rate of 11.2% during the 1990s, accelerated to 25.7% during the 6-year period ended March 2006. Despite this increase, the share of agriculture in total priority sector advances declined from 40.9% at end-March 1990 to 33.8% at end-March 2006. The share of



agricultural loans as percent of NBC of public sector banks was at 15.3% at end-March 2005 and 15.2% at end-March 2006. The agriculture loans as percent of NBC of private sector banks at 13.5% each at end-March 2005 and 2006 were much lower than the stipulated target of 18%. Some banks, especially new private sector banks and foreign banks, lack adequate branch network in rural areas as a result of which some of these banks find it difficult to achieve their priority sector credit targets. To address the problem, banks were asked to make deposits to the extent of shortfall in the Rural Infrastructure Development Fund (RIDF) of the National Bank for Agriculture and Rural Development (NABARD) for achieving the lending target. Foreign banks are required to make deposits in the Small Industries Development Bank of India (SIDBI).

- For increasing the flow of credit to agriculture and other rural sectors of the economy, several innovative measures were initiated in the form of Self-Help Group (SHG) - Bank Linkage programme and Kisan Credit Card (KCC) schemes. Micro-finance is now increasingly being recognised as a cost effective and sustainable way of expanding outreach of the banking sector to the rural poor.

The relative absence of interest subsidies, the high repayment performance and reduced transaction costs to lenders are some of the major advantages of micro-finance. There is now a growing realisation among the lending agencies that micro-finance programmes are bankable, creditworthy and profitable. *Banks are now discovering that people at the bottom of the pyramid can be brought into their business models.*

- The SHG-Bank Linkage programme is one of the 2 models of micro-finance. The flow of credit to the rural sector is hampered for 2 reasons. Firstly, credit is largely collateral based, and secondly, loan delinquencies are generally higher. Formation of joint liability groups in the form of SHGs helps in overcoming both these problems.

The responsibility for repayment of the loan is borne jointly by all the members of SHGs, who are engaged in some economic activity that generates the income needed for the repayment. Experience of SHGs in countries such as Bangladesh also shows that loan delinquency is lower in the case of SHGs due to peer pressure.

*The main advantages of the program are on-time repayment of loans to banks; reduction in transaction costs for both, the poor and the banks; door-step savings and credit facilities available to the poor; and exploitation of the untapped business potential in rural India.*

- The Self-Help Group (SHG)-Bank Linkage programme has emerged as an important model of micro-finance activity in the country (see Box IV.5). As at end-March 2006, 2.2 million SHGs were linked to banks with cumulative bank loans amounting to Rs.11 398 crore. The share of commercial banks in financing SHGs has increased over the years. The number of families assisted has increased by about 5-fold from 5 million in 2001 to 24 million in 2005. Further, the average bank loan per SHG increased from Rs.18 227 in 2001 to Rs.32 012 in 2005.
- The SHG-Bank Linkage programme, which till now has been concentrated largely in the Southern States, is expected to gain further ground with the NABARD taking up a programme for intensification of these activities in 13 identified states, accounting for 70.0% of the rural poor population.
- Although various types of products were available for providing credit to farmers, they lacked flexibility in terms of the amount needed for day to day requirements and its timely availability. In order to meet the liquidity requirements of farmers in a flexible manner, the Kisan Credit Card (KCC) scheme was introduced in August 1998 to enable the farmers to purchase agricultural inputs and draw cash for their production needs. At the inception of

the scheme, it was envisaged that investment credit requirements of farmers, viz, allied and non-farm activities would also be covered under the scheme. Since these activities were outside the ambit of the KCC scheme as announced in 1998, farmers had to approach the banks separately for their additional requirements, entailing additional time and cost, and observing banks' procedural formalities, including documentation.

- Therefore, revised KCC guidelines were issued in November 2004. The revised scheme aims at providing adequate and timely credit for the comprehensive credit requirements of farmers under a single window, with flexible and simplified procedures, adopting whole farm approach, including the short-term credit needs and a reasonable component for consumption needs.
- The KCC scheme has since stabilised. The cumulative number of KCCs issued by commercial banks, RRBs and co-operatives was at 59 million at end-March 2006 and the cumulative amount sanctioned was Rs.1,81,992 crore. While the number of KCCs issued by commercial banks increased in recent years, those issued by co-operative banks and RRBs declined. The share of co-operative banks in the cumulative number of KCCs issued was 51.5%, followed by commercial banks 36.9% and RRBs 11.6%. The amount sanctioned as percent of total outstanding loans was at 21.3% in case of RRBs and 7.5% in case of cooperatives. Amount sanctioned by commercial banks as percent of the total loans outstanding to agriculture was 9.8% at end-March 2006.
- **Credit to the Small Scale Industries sector:**

Another important segment of the priority sector is the small scale industries. The Small Scale Industries (SSI) sector is an important segment of the Indian economy. However, credit flow to the small scale industries sector decelerated in recent years as is evident from various indicators.

Firstly, the average annual growth of SSI advances decelerated to 9.5% during 2001 – 2006 from 13.6% during the 1990s. Secondly, the share of the SSI sector in total priority sector advances declined steadily from 44% at end- March 1998 to 18% at end-March 2006.

Thirdly, the share of credit to the SSI sector in NBC declined from 15.7% at end-March 1990 to 8.6% at end-March 2004. SSI advances by public sector banks were 8.1% of net bank credit at end- March 2006 as compared with 9.5% at end- March 2005. In the case of private sector banks, SSI advances accounted for 4.2% of NBC at end-March 2006 as compared with 5.4% at end-March 2005.

Fourthly, although credit growth to the SSI sector accelerated in 2004-05 and 2005-06, the share of SSI credit in total non-food gross bank credit and in total credit to the industrial sector continued to decline.

Fifthly, the number of loan accounts of the SSI sector in commercial banks declined from 219 million in 1992 to 93 million in 2005.

The main reason for slowdown of credit to the SSI sector was its poor performance and consequent risk aversion by banks. The activity of the SSI sector slowed down significantly between 1997-98 and 2002-03 with the value of production growing at an average annual rate of 7.7% as compared with 11.1% in the 1980s. The poor performance of the SSI sector was also reflected in the significantly higher level of NPAs in this sector (Table 4.14). Banks, therefore, became somewhat risk-averse and they reduced their exposure to the SSI sector.

In recent years (i.e., from 2003-04 to 2005-06), the performance of the SSI sector has improved. Accordingly, NPAs in the SSI sector have also declined significantly. This was reflected in the improved flow of credit to the SSI sector in 2004-05 and 2005-06 (see Table 4.6). As a result, the credit intensity of the SSI sector, after declining almost consistently between 1997-98 and 2004-05, increased somewhat in 2005-06. The credit to the SSI sector, to an extent, does not give a true picture as different banks appeared to have followed different definitions of the SSI sector. The definition of small and medium enterprises has now been clearly laid down in the Micro, Small and Medium Enterprises Act, 2006. Therefore, it is expected that there would be an improvement in the data reporting and the proper assessment of credit to the SME sector.

Given the significance of the small and medium enterprises, several measures have also been taken by the Reserve Bank to enhance the flow of credit to the SME sector. These measures, together with decline in NPAs in recent years, are expected to have a significant impact on the flow of credit to the SMEs sector in the coming years.

## 12.12 Emergence of household credit

Until the early 1990s, there were several restrictions for granting of personal loans. For instance, in the case of housing loans, the restrictions were in the form of:

- limits on total amount of housing loan to be given by all the banks in a given year;
- limits on maximum loan amount to individuals;
- prescription of rate of interest according to loan size;
- prescription of margin requirement; and
- prescription of maximum period of repayment.

All these conditions/restrictions were gradually removed in the early 1990s and banks were given freedom to decide the quantum, rate of interest, margin requirement, repayment period and other related conditions.

**These relaxations had a positive impact on the growth of personal loans.**

- Household or personal loans, on an average, registered a rise of 38.2% during the 5 year period ended March 2005 as compared with 25.2% in the 1990s; overall bank credit during this period increased by 20.3%. Consequently, the share of personal loans in total bank credit increased from 9.4% at end-March 1990 to 14.4% in 2000 and further to 22.2% at end-March 2005 (Table 2).
- The share of personal loans increased further to 25.2% of non-food gross bank credit at end-March 2006.

**Table 11: Growth and share of personal loans in total bank credit**

End March	Annual growth of total bank credit	Annual growth of personal loans	Share of personal loans in total bank credit
1	2	3	4
2001	17.0	27.7	12.2
2002	21.8	25.1	12.6
2003	15.2	38.1	15.1
2004	16.4	57.2	20.3
2005	30.9	42.9	22.2
Average (2001 to 2005)	20.3	38.2	16.5

**Source: Basic statistical returns of scheduled commercial banks in India, various issues, Reserve Bank of India**

- The number of personal loan accounts also increased sharply from 1995.
- Within personal loans, housing loans accounted for a little over one half of total loans, distantly followed by advances made against fixed deposits with a share of around 10.0% (table below).

**Table 12: Composition of household credit provided by commercial banks**

Category	Share in in total personal loans		Annual growth during 2006-06
	End march 2005	End March 2006	
1	2	3	4
i. Housing loans	55.5	52.7	44.8
ii. Advances against fixed deposits	12.2	9.9	16.9
iii. Credit card outstanding	2.4	2.6	59.3
iv. Education	2.1	2.8	96.5
v. Loans for purchase of consumer durables	3.7	2.5	-3.3
vi. Others	27.2	29.5	57.0
<b>Total ( i to vi)</b>	<b>100.0</b>	<b>100.0</b>	<b>44.4</b>

**Source: Annual report, 2005-06, Reserve Bank of India**

- Housing loans grew at an average annual rate of 47.7% during the 5 year period from 2000-01 to 2004-05. The average housing loan amount increased almost 4 times between end-March 2000 and end-March 2005. At end-March 2005, the average housing loan outstanding per account at Rs.3.45 lakh, which was more than 2 times the average amount in respect of all types of accounts of commercial banks.
- The share of housing loans increased steadily from 2.7% of total loans of commercial banks at end-March 1991 to 11.0% at end-March 2005.

## 12.13 Development component

Financial inclusion and financial literacy are complementary to each other. For emerging market economies, ensuring adequate access to financial products and services is more important at this stage but financial literacy creates demand for these products/services. In advanced economies, the access is not that much an important issue. Thus, it is a global problem with global dimensions.

## 12.14 India's financial inclusion/literacy architecture

The institutional structure for India's Financial Inclusion/Literacy programme is unique as it has an apex body in the Financial Stability and Development Council (FSDC), headed by the Finance Minister of Government of India, mandated, inter alia, to focus on attaining financial inclusion/literacy goals. With heads of all financial sector regulatory authorities being part of the FSDC, it seeks to ensure inter-regulatory co-operation for attaining the stated goals.

## **12.15 India's approach to financial inclusion**

### **12.15.1 Structured, planned approach**

India has a structured and planned approach to financial inclusion wherein all banks have prepared Board approved Financial Inclusion Plans (FIPs) with a 3 year horizon extending up to 2013. The initial goal of providing access to banking services to all villages with a population of more than 2000 by March 2012 has been successfully met. India is on its way to ensuring the same for all villages in a time bound manner. The focus is also on the volume of transactions in new accounts opened as a part of the financial inclusion drive.

### **12.15.2 Bank led model**

India has adopted a bank-led model for financial inclusion which seeks to leverage on technology. The FI initiatives would have to be ICT based and would ride on new delivery models that would need to be developed by the market participants to best suit their requirements.

Experience shows that the goal of financial inclusion is better served through mainstream banking institutions as only they have the ability to offer the suite of products required to bring in effective/meaningful financial inclusion. Other players such as mobile companies have been allowed to partner with banks in offering services collaboratively.

### **12.15.3 Minimum bouquet of products and services**

To meet the criterion of availability of banking services, a minimum of 4 basic products must be offered to customers:

- a check-in account with emergency credit facility;
- payment services and remittance facility;
- a pure savings product such as a recurring deposit; and
- facility of entrepreneurial credit to deserving people.

### **12.15.4 Combination of branch and business correspondence**

A combination of Brick and Mortar structure with Click and Mouse technology will be helpful in extending financial inclusion especially in geographically dispersed areas. Banks need to make effective use of technology to provide banking services in remote areas through the Business Correspondent (BC) model.

The BC model allows banks to provide doorstep delivery of services, especially cash transactions. To ensure increased banking penetration, and control over operations of BC, more Brick and Mortar branches are needed. In April 2011, banks have been mandated to allocate at least 25% of all new branches to unbanked rural areas. Banks have also been mandated to open



intermediary brick and mortar structure between the base branch and customer locations, which will lead to efficiency in cash management, documentation, redressal of customer grievances and close supervision of BC operations.

## 12.16 Financial literacy

As a complement to financial Inclusion, financial literacy aims to build peoples capability to use the financial products and services. As the first stage of literacy is to create demand, all institutions involved in delivery of financial products and services are contributing to our financial literacy agenda. This entails:

- devising appropriate products and services;
- pricing them reasonably, understanding the risk;
- communicating it to customers; and
- protecting the customers.

### 12.16.1 Multi agency central bank led approach

The Central Bank has taken a lead role in spreading financial inclusion and financial literacy. The Reserve Bank of India is actively contributing towards the goal of universal financial inclusion in the country, both in terms of creating an enabling policy environment and providing institutional support. FSDC has constituted a sub-committee to focus solely on financial inclusion and literacy.

It is well recognised that to be effective financial literacy initiatives should ideally commence at school level although even at a later stage adult education would provide substantial benefits. Realising this, in India, there is engagement with the curriculum setting bodies like National Council of Educational Research and Training (NCERT), education boards like Central Board for Secondary Education (CBSE), central and state governments, in the FSDC sub-committee on financial inclusion and financial literacy.

A large number of other players are involved. All other financial sector regulators, banks, insurance companies, pension funds, NABARD, corporates, industry associations, NGOs and other members of the civil society are actively engaged in this process. Thus, the basic approach could be described as a central bank led multi-agency approach.

### 12.16.2 National financial literacy strategy

One of the important tasks that the FSDC sub-committee is undertaking is to formulate our National Financial Literacy Strategy document. It is being finalised with the following objectives:

- create awareness and educate consumers on access to financial services, availability of various types of products and their features;
- change attitudes to translate knowledge into behaviour; and
- make consumers understand their rights and responsibilities as clients of financial services.

Contrary to popular perception, financial literacy has to be imparted to everyone in the economy – i.e. users and providers. In the Indian context, the users are broadly the financially excluded resource-poor, the lower and middle income groups as well as high net worth individuals. Equally important, banks, financial institutions and other market players too need to be literate about their risks and returns framework.



Policy makers including the financial sector regulators must have financial literacy to comprehend and gauge the requirement of the population and financial institutions to drive the agenda. However, the message to be conveyed, the method of communication, the language of communication, the complexity of subjects etc., would have to be tailored to suit the target audience.

The national financial literacy strategy in India is meant to get across simple messages shown in the box below:

Some of the questions that the FL initiatives seek to address are:

- Why open a bank account?
- Why should one save?
- Why save regularly and consistently?
- What is the difference between money and credit?
- Why borrow responsibly?
- Why borrow for income generating purposes?
- Why repay loans in time? Repayment ethics.
- Why do you need insurance?
- What are the benefits of being part of payment and settlement system?
- Why you will need regular stream of income post working life—pension?
- Why you should keep money aside regularly and consistently during your earning life for pension in old age?
- What is interest? How money lenders charge interest rates?

## 12.17 Consumer protection

To protect consumers is in the interest of service providers also. They need to appreciate that for their business to survive, their customers must survive, and for that, they need to understand the appropriateness of the products themselves. Efforts are underway to encourage simple plain vanilla products – where pricing and other parameters are easy to comprehend and are not too complex. However, as markets mature and more complex products become available, the need for financial literacy becomes even more paramount.

### 12.17.1 Pricing of products and services to protect the customer

The most important area for consumer protection is pricing of products and services. Regulation has to ensure that pricing is transparent, non-discriminatory and non-exploiting. Also, it should be ensured that pricing is affordable too.

For the most vulnerable sections of society who do not have many ideas about pricing, regulation should ensure formulation of standardised products and services by all market players. For other category of customers, market forces should determine the price.

## 12.17.2 Steps taken by RBI in promoting financial literacy

One of the objectives of the financial inclusion/literacy agenda is to ensure that the sections of the society that are hitherto undeserving of credit facilities are made credit worthy.

Initiatives such as setting up rural development and self-employment, training institutes (RUDSETIs) and financial literacy as well as credit counselling centres (FLCCs) by different banks are aimed at ensuring this.

Some of the other steps taken by RBI to promote financial literacy are as follows:

- Outreach visits by top executives of Reserve Bank of India to remote villages on a continuous basis – to spread the message of financial awareness and literacy.
- RBI website – a link on financial education in the RBI website for the common man, containing material in 13 Indian languages which includes comic books on money and banking for children, essay competition etc.
- Awareness – by distributing pamphlets, comic books, enacting plays and skits, arranging stalls in local fairs, exhibitions, participation in information/literacy programmes.
- Weekly radio programmes on financial literacy in some States by banks and similar programmes in tribal districts by NABARD.
- Awareness programmes on various government sponsored self-employment schemes involving bank loans and subsidy by government agencies like KVIC, DICs, SC/ST corporations.
- Mass media campaigns, tie ups with educational institutes, financial awareness workshops/help lines, books, pamphlets and publications on financial literacy by NGOs, financial market players etc.
- National and state level rural livelihood missions have large number of field functionaries for proper handholding support to large number of self-help groups.
- Large number of other websites/portals of banks/state level bankers committees disseminating information on banking services.
- Conduct of training programmes for farmers' club, NGOs and SHG members by NABARD.

## 12.17.3 Banking Ombudsman – quick and cheap forum of grievance redress

In India, there is a law for consumer protection though not specifically for the financial sector consumers. In regard to bank customers, we have the Banking Codes & Standards Board of India (BCSBI) which is the standard setting body for banking services. The self-regulatory organisation of the banking industry i.e., Indian Banks Association has evolved a fair practices code to be adopted by its members.

To ensure that consumers are protected even in case of plain vanilla products, the Reserve Bank of India has instituted the Banking Ombudsman, an alternate dispute resolution mechanism. The

government was also examining the possibility of enacting comprehensive financial sector consumer protection legislation.

## 13 ANNEXURE 2: DIFFERENT COUNTRIES' REGULATORY REGIMES

### 13.1 Introduction

Increasing the access of the poor to sustainable financial services is an important part of the World Bank Africa region's strategy for supporting the millennium development goals for poverty reduction. Convenient and affordable instruments for savings, credit, insurance, and payment transfers are both essential:

- to cope with the economic fluctuations and risks that make the poor especially the vulnerable;
- to take advantage of opportunities; and
- to acquire productive assets and skills that can generate increased income.

Microfinance is the application of innovative methodologies that make such financial services available to relatively poor households and microenterprises in small transactions suited to their conditions. Innovative microfinance institutions have had substantial success in making financial services accessible to the poor in many parts of the world. Microfinance is increasingly provided through licensed commercial financial institutions capable of mobilising the funds necessary to significantly increase the scale of outreach.

The literature on microfinance identifies the legal and regulatory framework as one factor that influences the emergence of different kinds of institutional providers of microfinance and, especially, their development into self-sustaining, commercial microfinance institutions capable of reaching growing numbers of poor clients, especially in rural areas.

Below, we present comparisons from selected countries in Africa, South America and Asia

### 13.2 Objectives

It is well documented that access to credit allows the poor and the small scale entrepreneur people to take advantage of economic opportunities. Reliable and regulated sources of credit with less onerous rules provide a fundamental basis for planning and expanding business activities.

Access to credit and conscious effort of increasing earnings and savings by households can contribute to transforming them from a survival to sustainable development. With more disposable income, families and small businesses are able to send children to school for longer periods and to make greater investments in their children's education. Increased earnings lead to better nutrition and better living conditions, which translates into lower incidences of illness.

Around the world, the microfinance community is paying more attention to consumer protection. Controversial topics such as high interest rates and the over indebtedness of borrowers, have raised public concern for poor consumers in countries far and wide, from Bolivia to Bangladesh to South Africa and beyond. Relatively little is known about how consumer protection might apply to financial services for the poor.

The very success of microfinance in demonstrating that poor people can and do repay loans has encouraged commercial lenders to enter some markets. More commercialisation is expected in the future. Moral arguments for consumer protection in microfinance focus on the imbalance of power between lenders and borrowers. Individuals who are functionally illiterate, first-time

consumers, or difference in language or ethnicity from the staff of financial institutions are particularly vulnerable. Even middle-income, relatively educated borrowers may be insufficiently informed about their rights and can be pressured into making poor borrowing decisions.

In addition to the moral arguments, there may also be strategic reasons for promoting or supporting consumer protection. A number of countries have imposed or are considering imposing interest rate ceilings in the name of protecting clients. Unfortunately, these ceilings end up hurting the poorest and most vulnerable customers by shrinking their access to credit.

Enhanced consumer protection measures can be a more constructive alternative to new or lowered interest rate ceilings. Lenders and policy makers alike may prefer this alternative if it avoids undermining the viability of the sector as a whole with artificially imposed rate ceilings. It assesses the 2 primary approaches to enforcement of such measures – voluntary codes and state regulation – in the context of developing countries.

## **13.3 South Africa**

### **13.3.1 Rules around credit granting**

In South Africa, microfinance consists of consumer-lending provided by banks, micro-lenders, and micro-insurance – particularly for burial costs. Only banks may accept deposits, and all banks are regulated by the South African Reserve Bank (SARB), (though there are certain enumerated exceptions). Micro-lenders may take forms such as NGOs, companies, cooperatives (including village financial service cooperatives), corporations, or trusts.

### **13.3.2 Rules around capping of interest or fees to be charged**

Credit providers, including banks, are regulated and must register with the National Credit Regulator (NCR), which technically falls under the umbrella of the Department of Trade and Industry. Small credit providers that conduct under a certain amount of transactions, or, less than a certain volume of business per year are exempted from registering. These include institutions such as stokvels (savings clubs), rotating savings and credit associations (ROSCAs), mashonisas (small cash-lenders) and burial societies.

### **13.3.3 Rules around the management of debt relief**

The NCR has established rules and procedures to deal with the whole ambit of debt management with the emphasis of fair treatment of consumers, debt restructuring, education and advisory service to the defaulter.

### **13.3.4 Development component**

The National Credit Regulator is responsible for the promotion and support of the development, where the need exists, in a fair, transparent, competitive, sustainable, responsible, efficient, and effective manner. The regulator has to ensure that the historically disadvantaged persons; low income persons and communities living in remote, isolated or low density populations and communities, have access to the credit market services in a manner consistent with the purposes of this Act.

### 13.3.5 Regulators

- South African Reserve Bank (SARB);
- National Credit Regulator (NCR);
- Financial Services Board; and
- Financial Intelligence Centre.

### 13.3.6 Laws and regulations

- Banks Act No. 94 of 1990 (amended through 2003);
- Microfinance & Banking Laws/Regulations;
- Reserve Bank Act No. 90 of 1989 (amended through 2003);
- Financial Services Board Act No. 97 of 1990 (amended through 2008);
- National Credit Act No. 34 (enacted in 2005);
- Regulations Pursuant to the National Credit Act No. 34 of 2005 (enacted in 2006);
- Financial Advisory and Intermediary Services Act No. 37 (enacted in 2002);
- Co-operative Banks Act No. 40 (enacted in 2007);
- Close Corporations Act No. 69 of 1984 (amended through 2006);
- Companies Act No. 61 of 1973 (amended through 2004);
- Co-operatives Act No. 14 (enacted in 2005);
- Non-profit Organisations Act No. 71 (enacted in 1997);
- Branchless Banking Laws/Regulations;
- Financial Intelligence Centre Act No. 38 of 2001 (amended through 2004);
- Regulations in terms of the Financial Intelligence Centre Act No. 38 (enacted in 2002);
- FIC Guidance Note 3 for Banks on Customer Identification and Verification (enacted in 2005);
- National Payment System Act No. 78 of 1998 (amended through 2008);
- SARB Guidance Note 06/2008 on Cell-Phone Banking (enacted in 2008);
- SARB Guidance Note 03/2008 on Outsourcing of Functions within Banks (enacted in 2008);
- Protection of Constitutional Democracy Against Terrorist Related Activity Act. No 34 (enacted in 2004);
- Prevention of Organised Crime Act No. 101 of 1998 (amended through 2001);
- Regulation of Interception of Communications and Provision of Communication-Related Information Act No. 70 (enacted in 2002);
- South African Reserve Bank Position Paper on Electronic Money (enacted in 2006); and
- Consumer Protection Laws/Regulations.

### 13.3.7 Consumer protection laws/regulations

- National Credit Act No. 34 (consumer protection-related) (enacted in 2005).

## 13.4 Nigeria

### 13.4.1 Rules around credit granting

The Central Bank of Nigeria (CBN) regulates MFBs and commercial banks. NGO-MFIs are not regulated. Due to severe financial sector problems including numerous bank failures and the sudden revocation of over 200 MFB licenses in 2010, the CBN promulgated several important amendments to the regulatory and supervisory frameworks for commercial banks and MFBs beginning in mid-2010.



The reforms currently underway include establishment of a tiered banking structure that attempts to better shield bank deposits from broad exposure to risk. Under the new framework, universal banking is no longer permitted, but rather banks must be licensed in 1 of these 3 categories:

- commercial banks;
- merchant banks; and
- specialised banks, of which MFBs are one sub-category.

### **13.4.2 Rules around capping of interest**

In January 2011, CBN also issued a new regulatory and supervisory framework and guidelines for providers of non-interest Islamic financial services, which may include some MFBs and other microfinance institutions. CBN revised its Microfinance Policy Framework in mid-2011.

### **13.4.3 Rules around management of debt relief**

The regulatory and supervisory framework for financial consumer protection in Nigeria is still in its developmental stage. The relevant legislation is the Consumer Protection Council Act No. 66 of 1992. This act creates a mechanism for consumers to file complaints and enables the Consumer Protection Council (CPC) to attempt to mediate and provide redress when it determines that a violation has taken place.

There is currently no agency or law in Nigeria specific to financial consumer protection, but the CPC's mandate encompasses all products and services. Amendments to the CPC Act that would expand the CPC's enforcement powers have been pending before the National Assembly for some time. In 2009, a very comprehensive National Consumer Credit Regulatory Commission Bill was introduced, but not passed by the National Assembly.

The Central Bank of Nigeria (CBN) also plays a role in consumer financial protection, despite a lack of specific legislation or regulation on this subject. The CPC has developed a practice of forwarding unresolved financial sector complaints to CBN for resolution. In late 2009, CBN began to take measures to address widespread card fraud, including a requirement that all Deposit Money Banks (DMBs) establish consumer help desks for ATMs. This was greatly expanded in August 2011 with a new circular requiring all financial institutions to have help desks to handle all consumer complaints within a certain timeframe, and report complaints regularly to the CBN.

### **13.4.4 Development component**

Microfinance services in Nigeria are mainly provided by formal institutions, such as microfinance banks (MFBs) and commercial banks, as well as less formal institutions, such as non-governmental organisations (NGO-MFIs), which may transform into MFBs upon satisfying certain provisions.

### **13.4.5 Regulators**

- Central Bank of Nigeria;
- Consumer Protection Council; and
- Nigeria Deposit Insurance Corporation.

### **13.4.6 Laws and regulations**

- Microfinance and banking laws/regulations;

- Banks and Other Financial Institutions Act (Act No. 25 of 1991) (amended through 2005);
- Central Bank of Nigeria Act (Act No. 7) (enacted in 2007);
- Companies and Allied Matters Act (Chapter 59) (enacted in 1990);
- Microfinance Policy Framework for Nigeria (amended through 2011);
- Regulatory and Supervisory Guidelines for Microfinance Banks in Nigeria (enacted in 2005);
- Regulation on the Scope of Banking Activities and Ancillary Matters (No. 3) (enacted in 2010);
- Prudential Guidelines for Deposit Money Banks in Nigeria (enacted in 2010);
- Guidelines for the Licensing, Operations and Regulation of Credit Bureaus in Nigeria (enacted in 2008);
- Framework for Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria (enacted in 2011);
- Branchless Banking Laws/Regulations;
- Regulatory Framework for Mobile Payment Systems in Nigeria (enacted in 2009);
- Anti-Money Laundering/Counter Terrorism Financing Regulation (enacted in 2009);
- Guidelines on Electronic Banking in Nigeria (enacted in 2003); and
- Money Laundering (Prohibition) Act (enacted in 2004).

### 13.4.7 Consumer Protection Laws/Regulations

- Consumer Protection Council Act No. 66 (enacted in 1992); and
- Circular on Handling Consumer Complaints (enacted in 2011).

## 13.5 GHANA

### 13.5.1 Rules around credit granting

In Ghana, institutions involved in microfinance include:

- formal institutions (banks and non-bank financial institutions, including savings and loans companies);
- semi-formal institutions (credit unions and financial NGOs); and
- informal actors (Sususavings collectors and traditional moneylenders).

The Bank of Ghana is the regulatory authority for formal institutions. Savings and loans companies and other non-bank financial institutions, previously subject to the Non-Bank Financial Institutions Act No. 774 of 1993, have migrated to the banking regime and are regulated under the Banking Act No. 673 of 2004, amended through 2007.

### 13.5.2 Rules around capping of interest

In July 2011, the Bank of Ghana issued new operating rules and guidelines for MFIs that cover the entire microfinance sector, including semi-formal and informal institutions that were previously unregulated. A new set of regulations are expected to follow. These will bring credit unions under the Bank of Ghana's supervision rather than that of the Department of Cooperatives and the Credit Union Association.

In 2008, the Bank of Ghana issued the guidelines for branchless banking authorising deposit-taking institutions to offer financial services through non-bank agents. For mobile phone banking, only the many-to-many model is permissible; telecom operators and authorised financial institutions are expected to offer mobile banking services to the general public.

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### 13.5.3 Rules around management of debt

Additionally, Ghana is focusing its attention on financial literacy and consumer protection efforts; although no consumer protection law currently exists. A national strategy for financial literacy and consumer education in the microfinance sector was launched in January 2009 and hosted by Microfinance Unit at the Ministry of Finance and Economic Planning.

The Investigation and Consumer Reporting Office (ICRO) within the Banking Supervision Department (BSD) of the Bank of Ghana has the responsibility of protecting financial consumers in Ghana, and education them on their rights and responsibilities. The ICRO regulates both banks and non-bank financial institutions, and receives customers' complaints, petitions and grievances for redress. It is mandated to investigate all forms of complaints and alleged irregularities between and among parties in the banking industry, including the microfinance sector.

### 13.5.4 Development component

In 2006, the Ghana Microfinance Policy recommended that MFI apex organisations be encouraged to develop and implement industry standards. In January 2009, Ghana approved a national strategy for financial literacy and consumer education in the Microfinance Sector. The main objective of this strategy is to improve financial capability as well as to educate customers on their rights and responsibilities. In addition, a complaint centre that specifically addresses the needs of consumers in the microfinance sector is planned to be created as part of this strategy. This proposed centre would play the role of Ombudsman for financial services.

### 13.5.5 Regulators

- Bank of Ghana (BOG); and
- Ministry of Finance and Economic Planning.

### 13.5.6 Laws and regulations

- Microfinance and banking laws/regulations;
- Banking Act No. 673 of 2004 (amended through 2007);
- Bank of Ghana Act No. 612 (enacted in 2002);
- Non-Bank Financial Institutions Act No. 774 (enacted in 2008);
- Credit Reporting Act No. 726 (enacted in 2007);
- Business Rules for Deposit-Taking Non-Bank Financial Institutions (enacted in 2000);
- Business Rules for Non-Deposit-Taking Non-Bank Financial Institutions (enacted in 2000);
- Operating Rules and Guidelines for Microfinance Institutions (enacted in 2011);
- Guidelines for Rural Banking License (enacted in 2005);
- Requirements for Non-Bank Financial Institutions Licenses (enacted in 2004);
- Branchless Banking Laws Regulations;
- Anti-Money Laundering Act No. 749 (enacted in 2008);
- Guidelines for Branchless Banking (enacted in 2008);and
- Consumer protection laws/regulations:
  - ICRO.

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## 13.6 Uganda

### 13.6.1 Rules around credit granting

Microfinance in Uganda has been built on the foundation of entrepreneurial clients. Microfinance services are provided by both formal and semi-formal institutions. The main institutions are commercial banks, credit institutions, microfinance deposit-taking institutions (MDIs), savings and credit cooperative organisations (SACCOs), and non-government organisations (NGOs). In addition, there are a number of moneylenders. The Bank of Uganda regulates commercial banks, credit institutions, and MDIs.

### 13.6.2 Rules around capping of interest or fees

SACCOs are supervised and monitored by the Department of Co-operatives within the Ministry of Tourism, Trade, and Industry. NGOs are monitored by the National Board of Non-Governmental Organisations housed at the Ministry of Internal Affairs. Over the past decade, a four-tier system for regulating and supervising institutions involved in microfinance has emerged in Uganda. Tier I consists of financial institutions, such as commercial banks. Tier II consists of non-bank financial institutions, such as credit institutions. Tier III consists of MDIs; and Tier IV consists of SACCOs and NGOs.

### 13.6.3 Rules around management of debt

These rules are inferred from the provisions of the Finance Deposit-Taking Institutions (MDI) Regulations No. 61 of 2004, issued by the Bank of Uganda, which addresses the following:

- licensing;
- liquidity and funds management;
- capital adequacy;
- asset quality, and
- reporting for microfinance deposit-taking institutions in Uganda.

#### 1 Licensing:

The regulations on licensing address information and guidance on the conditions to be fulfilled by an applicant in order to obtain a license from the central bank to engage in microfinance in Uganda. These regulations consist of the following sections:

#### 2 Liquidity and funds management:

The liquidity and funds management regulations include the following information on liquid asset requirement:

- internal policies and funds management;
- the role of board of directors;
- the role of management;
- the liquidity management process;
- remedial measures; and
- administrative sanctions.

#### 3 Capital adequacy:

The capital adequacy regulations consist of 3 sections which provide the capital requirements for microfinance deposit-taking institutions, which is not less than 500 million Uganda shillings, and the computation of capital adequacy.

#### **4 Asset quality:**

The asset quality regulations which among other consist of reporting on non-performing credit facilities, income recognition, and classification and provision of credit facilities; the power of the central bank to undertake inspections, which may include determining whether non-performing credit facilities have been accurately reported and that interest accrual is in compliance with these regulations, and addresses the establishment of a loan portfolio accrual system.

### **13.6.4 Development component**

Microfinance is geared to SME development and little literature exists that documents the high consumerism by households. The general population however has high literacy levels and the country has low HIV incidents in comparison to other African countries.

### **13.6.5 Regulators**

- Bank of Uganda.

### **13.6.6 Laws and regulations**

- Financial Institutions Act No. 2 (enacted in 2004);
- Bank of Uganda Act (Ch. 51) (enacted in 2000);
- Micro Finance Deposit-Taking Institutions Act No. 5 (enacted in 2003);
- Co-operative Societies Act (enacted in 1991);
- Non-Governmental Organisations Registration Act (Ch. 113) (enacted in 1989);
- Companies Act (enacted in 1961);
- Financial Institutions (Licensing) Regulations No. 41 (enacted in 2005);
- Financial Institutions (Capital Adequacy) Regulations No. 42 (enacted in 2005);
- Financial Institutions (Credit Reference Bureaus) Regulations No. 59 (enacted in 2005);
- Micro Finance Deposit-Taking Institutions (MDI) Regulations No. 61 (enacted in 2004);
- Co-operatives Societies Regulations (enacted in 1992); and
- Non-Governmental Organisations Registration Regulations (enacted in 1990).

## **13.7 Indonesia**

### **13.7.1 Rules around credit granting**

Indonesia, microfinance is predominantly provided by commercial and state-supported enterprises that include:

- commercial banks (BUs), particularly the unit DESA program the Bank Rakyat Indonesia (BRI), a primarily state-owned bank;
- government-owned savings and credit cooperatives (USPs);
- rural banks known as people's credit banks (BPRs); and
- local government-operated rural fund and credit institutions (LDKPs).

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## 13.7.2 Rules around capping of interest or fees to be charged

Bank Indonesia (BI), the central bank of Indonesia, regulates all commercial and rural banks. Cooperatives are supervised by the Ministry of Cooperatives and Small-Medium Enterprises. Rural fund and credit institutions are supervised by provincial governments (though technically required to obtain bank status). As legal frameworks focus mainly on banks and cooperatives, the legal status of and applicability of regulation for other formal and semi-formal institutions providing microfinance services can often be unclear.

## 13.7.3 Rules around management of debt

The National Consumer Protection Agency (NCPA):

- formulates consumer protection policy;
- encourages the development of consumer protection NGOs;
- disseminates consumer protection information; and
- accepts consumer complaints.

The Consumer Dispute Settlement Board, with offices throughout Indonesia, was established to provide a forum for out-of-court settlement of consumer disputes and has quasi-judicial powers of investigation and enforcement, including the ability to impose administrative sanctions. The Board also has the ability to control the inclusion of standard clauses in consumer contracts.

## 13.7.4 Development component

There are over 200 consumer protection NGOs in Indonesia, and they work to improve consumer awareness of their rights and obligations, as well as accepting consumer complaints and assisting in their resolution, bringing class action suits in the courts, and helping the government and communities in implementing consumer protection.

Indonesia has established policies to implement financial sector reform in recent years so as to minimise the risk of a recurrence of the economic crisis of 1998. Bank Indonesia, the independent central bank of Indonesia, has the primary authority to license, supervise and regulate banks, including those banks conducting business based on sharia principles. All banks are required to be members of the Indonesia Deposit Insurance Corporation (IDIC), established in 2004. The Minister of Finance has the authority to issue or revoke licenses of finance companies. The National Sharia Council has the power and function of issuing fatwas concerning products, services and business of banks conducting business based on sharia principles.

## 13.7.5 Regulators

- Bank Indonesia (BI);
- Ministry of Cooperatives and Small-Medium Enterprises; and
- National Consumer Protection Agency.

## 13.7.6 Laws and regulations

**Microfinance and banking laws/regulations:**

Banking and Microfinance:



- Act No. 7 of 1992 Concerning Banking (amended through 1998);
- Act No. 23 Concerning Bank Indonesia (enacted in 1999);
- Act No. 21 Concerning Sharia (Islamic) Banking (enacted in 2008);
- Regulation No. 11/1/PBI/2009 Regarding Commercial Banks (enacted in 2009);
- Regulation No. 8/26/PBI/2006 Concerning Rural Banks (enacted in 2006); and
- Regulation No. 6/27/PBI/2004 Concerning Supervision of Village Credit Agencies (enacted in 2004).

Cooperatives:

- Act No. 25 on Cooperatives (enacted in 1992) (Bahasa Indonesia);
- Act No. 9 Concerning Small Businesses (enacted in 1995) (Bahasa Indonesia); and
- Regulation No. 9 Concerning Saving and Lending Activities of Cooperatives (enacted in 1995) (Bahasa Indonesia).

Branchless banking laws/regulations:

- Act No. 15 of 2002 Concerning the Crime of Money Laundering (amended through 2003);
- Law No. 11 Concerning Electronic Information and Transactions (enacted in 2008);
- Regulation No. 11/28/PBI/2009 Regarding Implementation of Anti Money Laundering and Prevention of Terrorism Funding for Commercial Banks (enacted in 2009) (Bahasa Indonesia);
- Regulation No. 11/12/PBI/2009 Concerning Electronic Money (enacted in 2009);
- Circular No. 11/11/DASP Concerning Electronic Money (enacted in 2009);
- Circular No. 8/28/PBI/2006 Concerning Money Transfers (enacted in 2006) (Bahasa Indonesia); and
- Regulation No. 5/23/PBI/2003 Concerning Implementation of Know Your Customer Principles for Rural Banks (enacted in 2003).

### 13.7.7 Consumer protection laws/regulations

Indonesia's National Consumer Protection Agency (NCPA) was mandated by the Law No. 8 Concerning Consumer Protection, but did not commence operations until 2004. The NCPA falls under the Directorate of Consumer Protection, and statistics on its website reflect that about 50% of consumer complaints are about banking and financing services, out of only 56 reported cases. Banks must keep secret all information on depositors and their deposits. However, information on customers other than savings customers and depositors is not considered subject to bank secrecy requirements. In addition, there are certain exceptions made to permit disclosure and these are:

- to tax authorities;
- for use in criminal and civil proceedings;
- in legal proceedings between a bank and its customers;
- for information exchanges between banks;
- upon written request by a customer, or, their agent; and
- upon the request of a depositor's heirs.

Information disclosed between banks may only be disclosed to a director or specially designated officer of a bank.

The Credit Information Bureau (BIK) at Bank Indonesia officially opened in June 2006 and administers the Debtor Information System (DIS) by gathering positive and negative reports concerning both individual and business entity creditors. Membership in the BIK is mandatory for commercial banks, large rural banks, and non-bank credit card providers, and voluntary for smaller rural banks, non-bank financial institutions, and cooperatives. Individual Debtor Information (IDI) history can be accessed upon request by financial institutions, BIK members,

and the public, both as individuals and business entities. A complaint procedure has been established for those who claim that their credit history data is inaccurate. Credit referencing with the DIS no longer applies to microcredit loans.

- Law No. 8 Concerning Consumer Protection (enacted in 1999);
- Law No. 5 Concerning the Ban on Monopolistic Practices and Unfair Business Competition (enacted in 1999);
- Act No. 7 of 1992 Concerning Banking (consumer protection-related) (amended through 1998);
- Regulation No. 8/5/PBI/2006 Concerning Banking Mediation (enacted in 2006);
- Regulation No. 7/6/PBI/2005 Concerning Transparency in Bank Product Information and Use of Customer Personal Data (enacted in 2005);
- Regulation No. 7/7/PBI/2005 Concerning Resolution of Customer Complaints (enacted in 2005);
- Regulation No. 7/52/PBI/2005 Concerning Operation of Card-Based Payment Instrument Activities (enacted in 2005);
- Regulation No. 8/3/PBI/2006 Concerning Conversion of Business of Conventional Commercial Banks to Commercial Banks Conducting Business Based on Sharia Principles (enacted in 2006);
- Regulation No. 7/46/PBI/2005 Concerning Funds Mobilization and Financing Agreements for Banks Conducting Business Based on Sharia Principles (enacted in 2005); and
- Law No. 11 Concerning Electronic Information and Transactions (consumer protection-related) (enacted in 2008).

## 13.8 Malaysia

### 13.8.1 Rules around credit granting

Credit market conduct regulations was dispersed across various departments within BNM until 2006, when BNM established the Consumer and Market Conduct Department (CMCD) to increase attention to fair and equitable market practices and financial literacy of consumers. It formulates and implements consumer-oriented policies, supervises and enforces compliance with market conduct requirements, and promotes financial capability of consumers. Bringing market conduct for multiple financial service provider types under the CMCD umbrella was a milestone for the central bank, designed to level the playing field, enhance surveillance and enforcement capability, and improve financial literacy across the board.

### 13.8.2 Rules around capping of interest of fees to be charged

Supervisory activities include market conduct examinations, as well as mystery shopping and media surveillance (newspapers, Web sites, and brochures) to monitor disclosures, advertisements, and marketing and sales tactics. BNM follows a risk-based supervision model using surveillance activities, complaints data, and statistical information to prioritise follow up. A relationship manager manages both prudential and market conduct requirements for financial service providers as part of BNM's culture of interdepartmental cooperation. In fact, the market conduct department was originally staffed with former prudential supervision staff. BNM's Shariah Advisory Council plays an important role in interpreting and advising regulators and providers on relevant Shariah requirements with respect to product terms, conditions, and pricing.

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### 13.8.3 Rules around management of debt

An estimated 80% (435 000) of Malaysian small and medium enterprises are considered microenterprises. Only 13% of microenterprises surveyed in 2005 borrowed from formal financial institutions, relying instead on savings, family, and friends. Low-income customers have difficulty meeting bank requirements to obtain a loan, so borrowers such as hawkers and small traders often turn to loan sharks for financing as well. To bring more micro entrepreneurs into the formal financial sector, BNM has developed a microfinance framework to encourage lending to microenterprises by commercial banks and DFIs. Under the scheme, no collateral is needed and loan size ranges from RM 500–50 000 (US\$140–14 000). A detailed table, providing terms and conditions offered by regulated microfinance providers, is posted on BNM's Web site to facilitate comparison. A common logo was developed and participating banks as well as recipients are encouraged to display it to create awareness and understanding of microfinance.

### 13.8.4 Development component

BNM facilitates financial education for adults and students via outreach programs, including exhibitions, seminars, and briefings to inform consumers about their rights and responsibilities regarding specific products. BNM targets vulnerable or hard-to-reach groups such as women, students, rural communities, and retirees. It also uses Web resources, partners with financial service providers, and charges modest fees for financial education materials to keep the costs of programmes low. Lower-income consumers mainly learn about their rights and responsibilities from newspaper articles, radio and television programs on personal finance, community programs, fliers, and brochures.

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