Broadening Access to Affordable Housing

by Christine A. Glover

This article reflects exclusively my own experience within South Africa. This was acquired in two organizations established to broaden access first to housing finance and second to general finance. These two organizations were a finance company, The Group Credit Company (GCC), out of which developed the second entity, a bank named Cashbank. This paper, then, is a case history that may or may not have wider application than South Africa.

The products developed out of this case history have, in turn, had a mixed reception in South Africa. One of these products—a medium-term pension or provident fund secured loan—has found increasing acceptance with financial institutions as a product for the lower income housing market. The alternate product, essentially an unsecured micro loan that revolves five or six times, has only found acceptance in the non-banking finance sector. Even in this sector it is primarily a mechanism for entrepreneurial lending as opposed to a suitable mechanism for housing.

HISTORIC VIEW

Alternatives to traditional housing loans in South Africa developed out of a limited view of housing development processes. Housing standards on the one hand and political developments on the other also contributed to the paucity of alternatives.

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Prior to the 1980s private ownership of housing and the right to long-term access to a house was politically restricted. Access was mainly for the European population and primarily the more affluent sector of the population. The majority of the population was allocated rental stock and had virtually no wider choice, other than informal options created through personal inventiveness. Housing finance options to the majority of the population were therefore also exclusively informal.

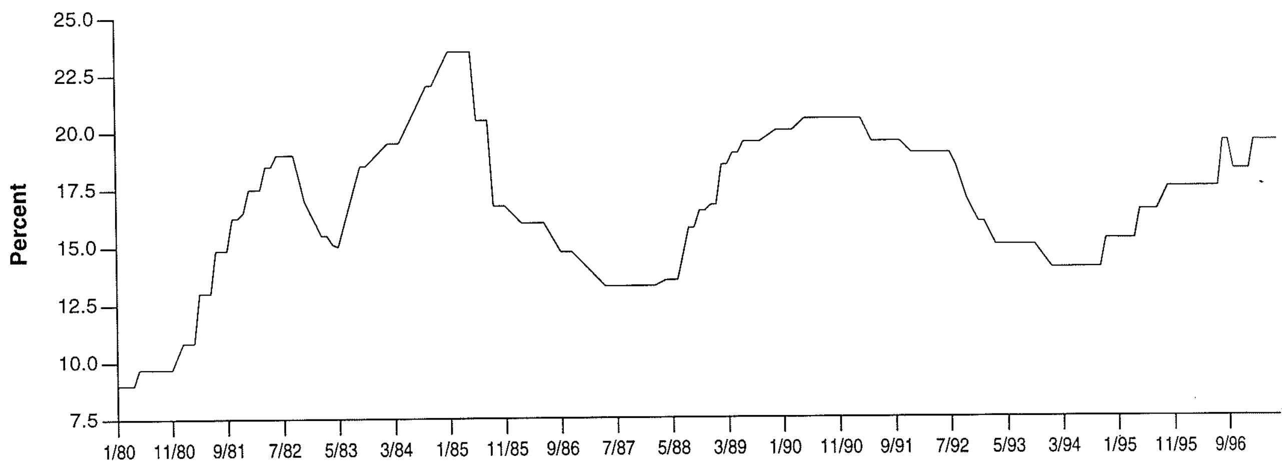
The formal market was characterized by a healthy, more affluent private sector funded either by cash or mortgage finance. The relative wealth of the market allowed for the comfortable imposition of fairly high-level housing standards. Because of the "normalized" state of the fairly restricted range of the market, financiers would normally find value.

In the 1980s the new right of the greater South African population to participation in homeownership left construction companies and financiers facing a series of new questions, namely:

- Relatively generous standards were laid down as minimum requirements, but if only a very restricted market could afford such standards, was an appropriate product possible? Would a modified product be accepted by both financier and client?
- Given that the greatest proportion of the population had not yet experienced private ownership in housing, was the assumption of market value attached to a house where no prior or current market existed a valid assumption? Therefore, was the security underlying the traditional mortgage product real?
- Since the size of housing loans to be acquired by the lower sector of the market would be considerably smaller than in the traditional market, was it possible to recover costs within the same margin? Alternatively, would the market accept a higher pricing for essentially the same product? Or would the political fall-out preclude such pricing?

The questions were answered by the late 1980s. In order to deliver the required size, house developers cut corners, resulting in a wave of housing schemes with significant product defects. These houses were further devalued through the lack of basic product maintenance by occupants used to rental stock purportedly maintained by the state. The initial housing schemes also came onto the market just at the beginning of a rising interest rate cycle, where the interest rate moved up six percentage points over a matter of months. Mortgaging in South Africa is normally done with a floating rate. Figure 1 gives an indication of the volatility of rates over a 17-year period.

Figure 1. Average Mortgage Interest Rates



People bought the houses at the bottom of the cycle, already stretching their borrowing capacity to the limit. A 6% increase on their mortgage interest made installments unaffordable. As the new purchasers already constituted the cream of the "new" market and as no secondary selling market existed, they were saddled with an unaffordable situation which had no apparent exit. The traditional approach of sell and buy down was not feasible. The scale of the housing shortage in South Africa placed a premium on occupying any house. No alternative accommodation existed.

The consequence of the loss of affordability, increasing prevalence of product defects and the absence of political development in South Africa, was the politicization of the housing process. This made it extremely unattractive from a financier's point of view. The requirement for the combination of a traditional housing product coupled with a traditional financial instrument (mortgage) relied on an active housing market to liquidate the security taken, i.e., the house. Real and perceived risks increased for financiers, and they largely withdrew from the market.

The perception that cemented in financiers' minds was not that the products delivered from both themselves and developers were inappropriate for the lower end of the market but that the market had too high a risk and required too costly an administration to be serviced by themselves.

RE-EVALUATIONS OF THE 1980S

Housing analysts in the mid- to late-1980s took the three key issues—security, administration costs and affordability—and searched for mechanisms which would reduce these barriers to broadening access to finance and housing. The resultant policy development took two forms:

- searching for mechanisms of making the traditional products more palatable, and
- developing alternative products.

Security

The initial analysis revealed that if the political risk and the product-defect risk were removed, the normal commercial risk appeared acceptable. The primary barrier to the banks' accepting the latter was a perception of considerably higher risk. The result of this analysis was that a variety of third-party insurance schemes were developed as risk reduction mechanisms. These mechanisms included:

1. A mortgage guarantee scheme that sought to insure 40% of the risk for the first three years of the life of the loan. This guarantee scheme sought to insure against the third risk, i.e., commercial risk. Since the risk embedded in this facet of lending was considered perceptual more than real, the ideal response was a short-term insurance that augmented the underlying security but was essentially limited in term so that the financiers would pick up the normal risk once the performance of the loan over

several years had proved the increased risk was definitely perceptual and not real.

This initiative, though a private sector development, was predominantly capitalized by a trust established with the fruits of the government's privatization initiative. The trust had been given the brief to improve the redistribution of resources to the underprivileged sector of the population, with particular regard to housing, business and education. The institutional framework under which the guarantee initiative was launched was that of a Section 21 company—a company not for profit, where the profits generated may not be distributed to external stakeholders.

2. A product defect insurance and developer registration system to overcome the historic development problems.

3. And finally, a short-term insurance scheme against the risk of politically induced boycott of payments. This insurance was designed as a safety measure during the period of political transition in South Africa from a system in which housing was one of the limited mechanisms through which political action could be expressed to a system which opened up a far wider range of avenues for political expression. This initiative, which was designed to offset the risk of politically inspired nonpayment, was a purely governmental initiative. It was part of a suite of initiatives to normalize and depoliticize the housing process, including the payment of local authority services such as the supply of water and electricity.

   The insurance scheme specified very tight criteria and specific geographic areas within which the government was prepared to secure the possible risk of a commercial lender not being in a position to collect payment or realize the asset because of local political activity creating "no go" zones. In these zones individuals, regardless of their willingness to fulfil their contractual obligations, would be obliged to follow the local political imperatives and would become reluctant participants of non-normalized housing market zones.

   It was essentially a short-term or transitional insurance, as other activities in the "suite," e.g., educational programs, which together with increasing normalization of the political process were hoped to overtake the need for political insurance.

Valuable as these new mechanisms were, they were still premised on the assumption that mortgaging remained the most suitable housing finance mechanism, and the delivery of a completed house of a certain size and standard the most practical (and not just desirable) housing process.

Alternative Products

Alternatives to this mechanism were only sought when political imperatives started demanding that access to housing and housing finance had to include a broader range of people and not only those for whom a mortgage was an affordable option.

Two alternatives appeared. The process of evaluation included informal financial processes which were delivering loans and savings to the hitherto unbanked. These indicated evidence of extensive use of informal cross-suretyships for relatively small sums of money over short periods. There was furthermore an increasing exposure to consumer loans through retail stores offering credit. Both of these products were offered at interest rates considerably higher than the formal financial institutions charged.

Secondly, there was the recognition that many lower income individuals had considerable financial value to their credit in various pension and provident funds. The potential use of these funds became an intense moral debate. Was it morally acceptable to tie a person's pension fund benefits to housing and thereby put the benefits at risk? Similarly, was it morally correct to ensure that a person accrued pension fund benefits but lacked a house and associated services, and, as a consequence, might be more exposed to health risks?

A consequence of the debate was that legislation was introduced allowing pension funds to be used either directly (as a loan to the person concerned) or as guarantees to third parties (employers or banks).

This opened up the possibility to think creatively about the actual financial product. It was no longer necessary to require even minimal home loans to be fairly substantial in size, as the cost of claiming a guarantee against a person's pension fund benefit and the cost of realizing such security was extremely small compared with the cost of realizing the value in bricks and mortar.

Smaller loans became feasible. Financial instruments could be developed which would match the actual housing processes happening in a country where the shortage of fully developed housing grew annually. The bulk of the population was part of a process which is referred to as incremental housing development. This involves the staged development of a house often over a considerable period of time. The starting point could be everything from a site and service scheme, a starter house, a shack, informal dwelling or even developing in the backyard of a relative's house.

Added housing value was the requirement in order to use pension fund benefits for security. The standard, form or location of housing no longer had relevance, as the house itself was no longer the security.

Administration Costs

The reality of the considerably higher administration costs of relatively small loans was the

next issue to be addressed. No solution was found for the additional costs when the financial product was a mortgage. Politically it remains unacceptable to charge higher rates to low-income people for a particular product.

However, two alternative mechanisms were created. By delinking housing loans from mortgages, the opportunity was created to link them to more appropriate forms of existing products, such as installment credit or consumer credit. Shorter term finance (1–5 years) and loans that do not exceed about four times a person's monthly income could attract interest rates of 4% higher than mortgage loans if fully secured, and 13% higher if unsecured. Risk of default on unsecured loans is between 7 to 10%. The additional margin above the credit risk is required for the much more intensive administration required.

Affordability

Affordability remains a key issue in the provision of mortgages. A range of modifications to the core mortgage product has been introduced to soften affordability problems, but none has found acceptability in the market. These other options include :

- Linking repayment to a percentage of income; the repayment therefore increases with time.
- Offering fixed-rate loans.
- Linking payments to pension funds with payments to the bond. The fund foregoes cash flow for a certain number of years and then accepts a gradually increasing contribution. This is purportedly to make up for the contribution holiday in the initial years of enlarged payment on the mortgage.

  In South Africa an individual's contribution into pension funds would average between 12% and 20%. Percentage of income that would be accepted as a norm for mortgage repayments is 30%. The initial combination of the allocation for housing and the pension allocation allows for between 40% and 50% of monthly income to be spent on housing.

  The pension contribution remains untaxed but must in a later phase be caught up out of taxable income. The additional value is seen as a pension fund investment.
- The state also attempted to ease affordability by introducing a capital subsidy which is applied on a tiered basis dependent on income level. The principle behind the capital subsidy is essentially to reduce the capital balance requiring financing and therefore to increase the access level of people to a minimum level of housing.

Shifting the loans from mortgages, however, introduces greater choice and greater flexibility. Premised on the fact that the most appropriate form of housing delivery for the lower income sector is incremental housing development, it remains more appropriate to match the financial product to the development process than vice versa. Shorter term, smaller loans but at a higher interest rate match the housing process. More importantly, they tend to match the exigencies of the household patterns of the low-income earner.

Long-term stability is not a pattern of such households. Economic downturns hit these households first, and personal crises abound: critical health problems in a member of the family, multiple pregnancies or a financially contributing family member retrenched. Complex loans that have an extremely long cycle with no short-term cash flow relief in sight are an anathema in these circumstances.

THE DEVELOPMENT OF CASHBANK

The original company, the Group Credit Company (GCC), was created in 1989 in order to test some of the alternative financial products for housing. The concept of the prevalent informal method of ensuring repayments through the use of cross-suretyships and cross-evaluations between a relatively small group of people was referred to earlier. The initial product tested by the GCC utilized this method to see on what scale it could be successful with regard to size of loan, length of term and size of groups. The target market was the self-employed and casually employed.

The experiment basically established that it was a successful mechanism provided that the term never exceeded one year, the sum did not exceed about one month's income and the group preferably numbered fewer than 10 people.

The findings are summarized below :

1. Deposits against the loans were an important aspect of security.
2. The greatest sensitivity in managing these loans was the structure of the product, in particular, the term. Twelve months was optimum. Twenty-four months resulted in a trebling of the bad debt figures. A further twenty-four months doubled the bad debt figure again.
3. Trust as a basis of assessing potential repayment for sums of money which fall within daily personal cash flows (the normal basis of group assessment) works exceedingly well. However, the difference of working with installments which might require a full month's salary of one member of a family was not recognized by groups. The consequence of utilizing the informal method of assessing members was the invariable over-commitment of a person's capability.

The group mechanism of assessing an individual member's ability to pay is only

effective for short-term loans involving relatively small sums of money. As the sums of money moved beyond commonly used limits, the basis of assessing affordability became need and not ability to pay. Affordability over the medium term in our experience is also not easy to assess for even an experienced credit officer, as one is dealing with a sector of the population that is characterized by irregular income, cyclical employment and differing monthly priorities for use of disposable income.

4. People only exert peer pressure if they are not disadvantaged personally by such action for a prolonged period.

5. Continued pressure over a 60-month term operates to the disadvantage of the good payers as they:

   - directly bear the transport costs of contacting the other members;
   - are subjected to personal abuse and threats by the people who are unwilling to pay;
   - soon perceive that they will lose any money that they personally put into the kitty to bridge short payments by others;
   - and recognize that the performance of some members will permanently prejudice their own record and that they personally do not have the means or methods to rectify the situation.

   Such pressure is possible and feasible in the short term but is not sustainable as a principle to ensure repayment over the medium term. The perception of groups once they have experienced significant long-term problems is that the system of joint and several responsibility is intrinsically unfair and inequitable. Consequently, it is more to their advantage to join the ranks of the nonpayers.

6. In the target market of high-risk housing loans, collectibility depends on:

   - Ensuring affordability (which is heavily influenced by short-term environmental issues whether due to family problems or economic downturns).
   - Ability to personally contact; one collects more through a personal collection system than through an impersonal, hands-off mechanism.
   - Rigorous regular contact with clients who do not have an automated payment system.
   - Relatively small repayments; large installments are only maintainable in the short term.

7. In terms of product design, simply keep the term as short and the size as small as possible.

As an instrument for housing delivery, this product was clearly very effective as support for people in informal housing areas but offered only limited application to people accessing more formal housing options.

It had further drawbacks in that it was extremely costly to manage, requiring extensive contact with clients and significant management support. It is, however, possible to price for this additional cost. The market, which is used to informal money lender rates of around 1000%, finds interest rates of less very attractive. The Usury Act, which sets maximum interest rates for most loans, allows small, short-term loans to be exempt from the Act in South Africa.

In a country where an increasing number of people are both self-employed and live in informal areas, the loan will have ongoing relevance but has inherent problems in scaling due to the intensive administration required.

A further experiment was introduced replicating the same product but for individuals, recognizing that the loans were entirely unsecured, not even benefiting from cross suretyships. The loans performed satisfactorily within the same product design criteria as the group loans and with a performance which is extremely similar to consumer credit.

The profile of the client for these small loans does, however, differ from a more traditional banking client, whether done within a group framework or individually. The client tends to be older—in excess of 40 years of age. It is often a client who has only limited experience of urban opportunities and might well be a migrant who is using the loan to improve housing in the rural areas. It is frequently an individual who has never had credit before. In other words, the client tends to be the more mature person, casually or self-employed, of either gender, whose connections to the rural areas are still strong.

Useful as this product is, it remains no real alternative to a mortgage and does not complement formal incremental housing development processes. In order to achieve this, the structure of the product needed to shift from a term of 12 months to one that is between 60 and 84 months; and the size of the loan needed to increase from an average half an individual's monthly salary to four times the monthly salary.

The significant increase in risk that this implied raised two issues :

- How to secure such a significantly larger loan?
- How to put a process of collection in place that was more reliable and cost efficient?

Both issues were resolved by some GCC clients who offered their pension fund benefits as security and payroll deduction as a form of collection, provided they could borrow longer term and for larger sums.

The product was launched, performed exceedingly well and required a bank to deliver the product at a greater scale. Consequently, Cashbank was born.

CASHBANK
Profile Client

The different product also brought a different profile person. This person was by definition not only formally employed but had been so for a fairly lengthy period of time in order to accumulate sufficient pension fund benefits. The person was therefore considerably more urbanized.

The average age of the client was younger, with 40% of the clients in the 30 to 39 age category and a further 32% in the 40 to 49 age category. The fully employed low-income person tends to be male, except in the textile industry. Consequently, 86% of the clients are male.

The result of being a more urbanized client is that this loan will not be his first exposure to credit, though it may be the first exposure to credit from a bank.

The product has successfully reached the income level where mortgage loans are not feasible (roughly R2500 per month). Figure 2 illustrates loan distribution by monthly income.

An analysis of the S.A. Central Statistical service's latest income figures indicates that Cashbank through this product is reaching well below the average income (see Table 1).

Cashbank's greatest geographic exposure is in Gauteng.

Figure 2. CASHBANK's Loan Distribution by Monthly Income

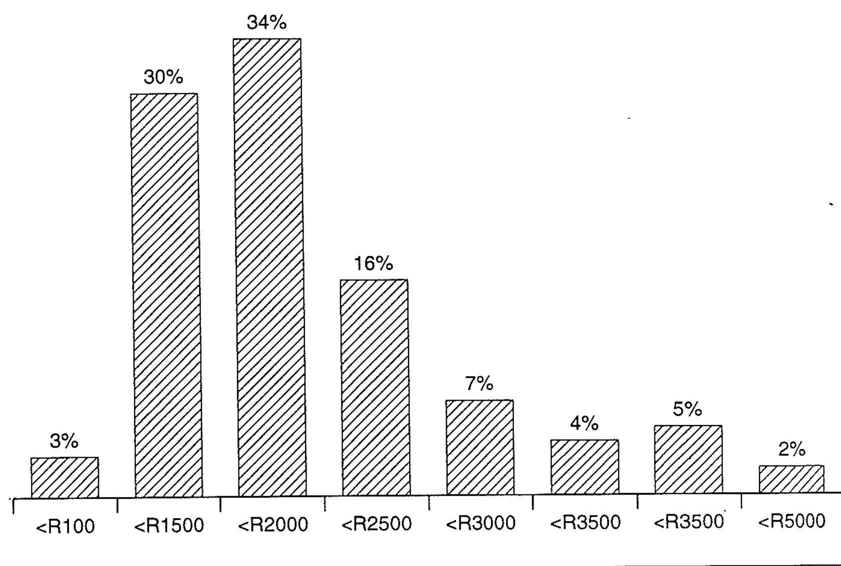


Table 1. Average Annual Household Income by Race of Head of Household in Each Province

Province	*African*	*Coloured*	*White*	*Total*
Eastern Cape	R17,000	R24,000	R90,000	R24,000
Free State	R14,000	R16,000	R72,000	R25,000
Mpumalanga	R20,000	R30,000	R82,000	R30,000
North West	R21,000	R25,000	R93,000	R30,000
Northern Province	R26,000	R43,000	R140,000	R31,000
Northern Cape	R13,000	R18,000	R79,000	R31,000
KwaZulu-Natal	R24,000	R41,000	R98,000	R37,000
Western Cape	R22,000	R33,000	R98,000	R53,000
Gauteng	R37,000	R53,000	R118,000	R71,000

Loan Usage

As the actual form of housing use of these loans is not predetermined by the bank, it is interesting to analyze the actual use and note the personal building priorities (see Figure 3).

However, as the use is only monitored and spot-checked, not absolutely controlled, leakage into other areas occurs, averaging 15%, and tends to be primarily into consumer goods (see Table 2).

Notwithstanding the leakage, considerable additional loan-to-value ratio is attained, as most borrowers do their own building work or utilize small private subcontractors and tend to source cheaper materials.

Figure 3. Loan Usage

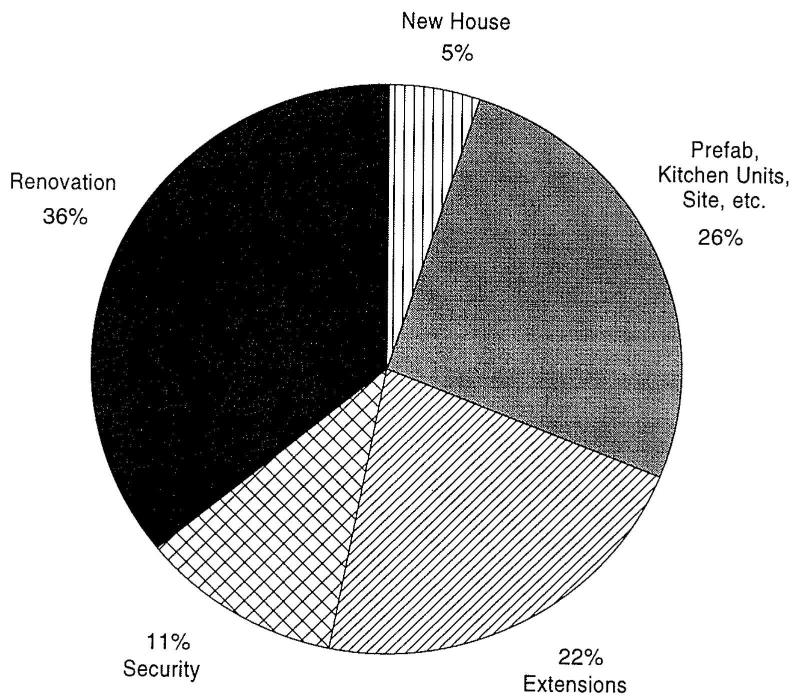


Table 2. Fifteen Percent Leakage

Furniture	28%
Car	10
White Goods	30
Debt & Other	32
	100%
(Multiple Applications	23%)

The value-to-loan ratio over the entire body of loans is 117%. If the loans which were clearly not used for housing are excluded then the ratio increases to 142%.

Risks

The first concern normally when lending to the low-income market is that of credit risk. This loan, however, by design transfers this risk to pension and provident funds. The key aspect in managing this risk, therefore, lies in assessing the risk attached to individual funds.

In South Africa, pension funds can be roughly divided into three categories. First, large industrywide funds with significant sums of money under management. Examples of these are: the Clothing Workers Provident Fund, the Motor Industries Provident Fund, the Mines Pension Fund and the Metal Industries Provident Fund. These funds are significant institutions in their own right; they are dedicated to all aspects of fund management and efficient service for members. The focus of their business has allowed for the streamlining of processes surrounding individual member fund management.

The second tier of funds tends to be smaller company-specific funds, managed and administered by life officers or administered by brokers who pool the funds and parcel this pool out to specific life officers and investment vehicles. The more diversified focus of these institutions tends to decrease the efficiency with which they handle individual member issues. Risk is not increased but cost is, as the number of times the bank has to interact with these institutions increases significantly.

The third category of funds is company-specific funds which are both managed and administered by the company concerned. These funds tend to be risky due to management's ability to potentially put the funds at risk.

The real risk in terms of managing these loans tends to be operational. Individual guarantees still need to be applied for each loan no matter how small. The management of the paperwork between funds and the bank allows for errors. Unfortunately, these interactions are still not electronic and will not be electronic in the foreseeable future.

The difficulty of collecting installments from the lower end of the market has been offset by approaching companies to deduct at source, i.e., payroll deductions. This again changes the normal nature of most banking interactions, as most processes have to be bulked and batched for efficient administration. Traditionally banking is individually focused at every stage of a loan or loan management. Computer systems that are banking-based do not have efficient mechanisms of bulk handling of small loans.

The illustration of the effectiveness of the combination of pension/provident fund security combined with payroll deduction as a collection method lies in the very reduced level of doubtful debt provisions required. These are currently 0.32% of the secured book. Two-thirds of these provisions in turn are general and not specific. The capital value outstanding on all secured accounts in arrears equals the amount provided as doubtful. In other words, the provisions made are very conservative. Bad debt write-offs over a two-and-a-half-year period as a percentage of money advanced is less than 0.2% for the full period. There are only two reasons for this write-off: one, unregistered guarantees, which account for half of the write-offs; and second, short claims. Short claims occur with loans where we have agreed to take a measure of risk (normally no more than 25%), and we have to institute a claim before the capital outstanding has reduced the bank's proportion of the risk to nil.

There is only one reason why claims are made and that is when the individual concerned leaves the employ of a particular company, either through resignations, retrenchment or firing. Claims, therefore, tend to closely follow changes in particular industries.

At any point in time 1% of the value of outstanding advances are in claims, with an average settlement period of 31 days.

Over the last three years that this product has been on offer, claims to the value of about 10% of advances have been processed.

The issue for banks now entering the market with this product is not the credit risk attached but whether the banks can manage the administration of bulked high-volume, low-value processing, when not fully automated. However, as automation increases between institutions there should be fewer barriers to managing this product.

CONCLUSION

The pension fund-backed loan is the first real alternative to mortgages that has been made available in the South African market.

The problems of managing the loans cease to be the classic ones of credit but become much more operational and administrative, i.e., managing low-value, high-volume loans cost effectively.

The precedent of how to achieve this is not to my knowledge found in the banking sector but is found in consumer credit organizations, medical aids and insurance companies.