Mortgage Bondage? South Africa's Financial Institutions and Low-cost Housing Delivery

by Mary R. Tomlinson

During the past decade, the commitment of South Africa's financial institutions to the delivery of low-cost housing has been repeatedly questioned, and much of the national housing backlog has been attributed to a lack of end-user finance for low-income people.

The institutions have as often responded that they 'cannot afford not to be' committed to lending to low-income people, but have quickly clarified this by adding that, before they are able to become active at scale in the low-income housing market, certain environmental and institutional constraints must be addressed. Their critics, though, have argued that the institutions cite constraints to mask their lack of interest in this market.

TIME AND ENERGY EXPENDED

If the institutions have indeed not been interested in the low-income market, they have devoted a great effort over the past decade to feigning interest. They and their organizing bodies have spent long hours with the government, and in some cases activist groups, negotiating a variety of agreements aimed at unblocking the logjams which have impeded the flow of finance into this market.

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Time and resources also have been devoted to developing new initiatives, institutions and instruments to cater to this market's needs. Energy has been directed at how—not whether—to ensure that end-user finance is available to low-income borrowers. As this study shows, however, it is generally agreed that these efforts both by government and the financial institutions have not achieved their intended effect, namely, enabling low-income people to access the financing required to address their housing needs. Where does the problem lie? This paper[1] seeks to answer this question.

Is end-user financing still beyond the reach of most low-income people because the institutions are indifferent or hostile to this market, as some of their critics insist? Does the problem lie rather with the government's failure to create the appropriate environment for low-income lending, as some in the institutions suggest? Or is the assumption that mortgage finance is the most suitable vehicle for addressing the accommodation needs of the homeless itself flawed?

The study relies on interviews conducted in June and July 1997 with representatives of the financial institutions' organizing bodies; of each major bank in this market; of non-traditional lenders;[2] and of the recently established government initiatives[3] intended to deal with lenders' risk. The vast majority of individuals interviewed had been operating in the low-income housing market for several years; this allowed them to offer informed insights on the period under discussion.

THE RECORD OF UNDERSTANDING

For almost three years, the attempt to unlock conventional end-user financing for low-income people has been governed by a Record of Understanding[4] (ROU) concluded in October 1994 between the Department of Housing (DOH) and the Association of Mortgage Lenders (AML), following negotiations aimed at creating a "stable public environment" which would be conducive to the resumption of lending to low-income borrowers. Agreement was reached on persuading township residents to abandon bond boycotts, and mortgage lenders agreed to return to the low-income market and provide 50,000 mortgages in the first year.

The ROU was negotiated against a backdrop of discussions in the National Housing Forum (NHF)[5] on how to encourage the re-entry of financial institutions into the low-income housing market after their almost universal exit from it in the early 1990s. The exit was ostensibly in response to their inability to secure mortgage loan repayments, which was often attributed to bond boycotts, one of the latter-day tools of the 'struggle.'

Institutions insisted their re-entry was constrained by their inability to repossess a house when a homeowner defaulted on mortgage payments, as well as a lack of quality control in the building industry, which often resulted in poorly constructed houses for which consumers were not inclined to continue paying.

Community groups responded that repayments would not improve until low-income people could see an improvement in service delivery; they complained too that their constituencies were upset at the unresponsive way in which they believed the banks were treating them.

Breaking the Deadlock

The ROU was the culmination of a twofold attempt by government to break the deadlock. First, it increased pressure on the institutions to become involved in a search for a solution by using veiled threats of nationalization if they did not significantly re-enter the low-income market. It also agreed to launch a "vigorous and unprecedented national and provincial campaign" to persuade consumers to resume payments and to reinstate law and order. The campaign known as Masakhane ("let's build together"), was seen in government circles as crucial to the success of the new housing program.

The housing program pivots on a new housing subsidy scheme (*Housing Subsidy Scheme*, 1995). A once-off capital subsidy is available to all households earning less than R3,500 ($745) per month (nearly 86% of South Africa's households). The amount of the subsidy ranges from R5,000 ($1,064) to R15,000 ($3,200), with the greater subsidy going to the households with the lesser income.

Noteworthy is the fact that the subsidy is linked to ownership. That is, beneficiaries can access a subsidy if they purchase a housing option. A housing option, depending on the amount of the subsidy and whether the beneficiary had additional funds, or access to end-user financing, could end up being: a serviced site; a serviced site with a rudimentary structure; the insitu upgrading of a shack community; or a portion of the cost of either a house or a flat. The *White Paper* (1994), presented to the cabinet at the end of 1994 by the then new Minister of Housing, Joe Slovo, characterized this strategy as progressive housing.

Capital Subsidy Inadequate

Knowing that the capital subsidy was not going to come anywhere close to delivering a four-room house—one of the ANC's pre-election promises to the homeless[6]—it became imperative to find ways of encouraging the banks to provide end-user financing in order to maximize the value of the subsidy. The view was that for those households with some income (who are mainly formally employed) a mortgage bond would provide the additional financing required to purchase something close to a four-room house.

A key element of the ROU was the establishment of a Mortgage Indemnity Fund (MIF) which would be used to cover accredited lenders if they were unable to repossess properties via the normal legal channels once default had occurred. The MIF was launched in June 1995 as a wholly government-owned company. Seen as an interim measure until normality was re-established (up to three years), the expectation was that it would be able to unlock significant mortgage lending to the low-income market.

Additional Initiatives

Two other initiatives aimed at breaking the deadlock were SERVCON Housing Solutions and a Home Builders Registration Council (HBRC). SERVCON, launched in June 1995 as a joint venture between government and the AML, was given the mission of dealing with the properties that had been repossessed (PIPs) by the banks after a sale in execution, but which the banks were unable to repossess due to the breakdown in law and order. SERVCON was also to assist borrowers with non-performing loans (NPLs) after a bank had found itself unable to reschedule defaulting loans. These procedures were designed to unlock what became known as the ring-fenced book.

Finally, as a means of addressing the shoddy workmanship prevalent in the low-income market (which is often at the nub of a household's decision to stop repaying a bond), a Home Builders' Registration Council was launched in June 1995 to register builders delivering bonded houses in the low-income market. Consumers would be protected where builders delivered shoddy products and did not honor their warranty obligations.

THE RECORD IN CONTEXT

As previously mentioned, the ROU was a culmination of attempts to unlock end-user financing at the lower end of the market. These attempts had been made for several years but were given greater urgency in 1994 by the government's promise.

As early as 1989, the government had appointed a Committee of Ministers to investigate a financial strategy to break the housing logjam (The Housing Finance Strategy Committee 1990). The investigation's point of departure was that one of the most significant constraints to increasing the supply of housing for urban black people was their inability to afford the housing products[7] which were then supplied. In 1989 the cheapest houses on which bonds were granted were in the R43,000 ($9,500) price range; only the top 10% of urban black families could afford them. A fundamental constraint to moving the private home building industry down market was thus seen as the reluctance of the financial institutions to provide loans of less than R35,000 ($7,500).

After detailed discussions, it was concluded that it was reasonable to expect the institutions to lend in the conventional and starter submarkets. It was not, however, seen as reasonable for them to enter the incremental or informal submarket. Hence, efforts were to be made to persuade the financial institutions to enter the starter submarket, where it was assumed more than 30% latent housing demand resided.

CONSTRAINTS TO MOVING DOWN MARKET

The conclusions reached by the Housing Finance Strategy Committee were based on the constraints of profitability and risk identified by the financial institutions. On the first score, loans of R35,000 were viewed as less profitable.

On the second, the risk perception of the financial institutions was such that they saw themselves being asked to operate in an environment in which they would be exposed to both commercial and political risk. The severe deterioration in the economic environment during this period of initial lending into the urban black market manifested itself in job losses and high interest rates (which rose from 13% in 1987 to 20% in 1989), severely threatening borrowers' ability to repay their loans. From this experience the banks quickly concluded that poorer households pose a greater commercial risk than higher income families. As previously described, the political context of the late 1980s and early 1990s also affected default rates—labeled as political risk—in some black areas.

Despite their exit from the low-income market, the institutions began searching for ways to reduce their risk, as a response to signals from government that their presence was being counted on to address the housing backlog. They began considering new approaches to problems in the low-income market.

New Approaches Tested

First, the banks developed the idea of spreading the risk among themselves on an equitable basis so that no single institution would be swamped by it. Second, a Home Loan Guarantee Company (HLGC) was established in 1990 to provide guarantees to banks and building societies. Besides reducing the risk to a financial institution, the scheme provided a mechanism to assist potential borrowers who could not raise the 10% deposit required. Only a 5% deposit or a similar amount of collateral was required—generally an employer guarantee would suffice—with the remainder of the deposit to come from the purchase of deposit replacement cover. The HLGC was thus seen as a potential means of significantly addressing affordability constraints by aligning the purchase of a house more closely with what the potential borrower could afford.

Initiatives were also explored which would use pension funds directly for housing assistance. In most cases, an employer provides a guarantee for the downpayment. This is then backed by pension, provident or retrenchment benefits. This approach is also intended to reduce or remove the deposit normally required by a financial institution and replace it with other collateral guarantees.

WEIGHING THE EVIDENCE

Almost everyone interviewed noted the positive spirit in which the ROU was signed. After the agreement was in place, many institutions formulated extensive lending plans based on the soon-to-be normalized lending environment.

Contrary to this expectation, three years down the road, the institutions and their organizing bodies insist that government has not normalized the lending environment. Reasons for this, they argue, include the fact that the Masakhane campaign has failed to restore a culture of payment; that civil disobedience remains rife against enforcing contracts; and that the criminal justice system has partially collapsed, making it extremely difficult for the legal enforcement of court decisions on household evictions to be enacted. This view was supported by all but one of the executives of the government's initiatives as well.

The target of providing 50,000 mortgage loans to low-income borrowers in the first year of the agreement was not met. All the stakeholders seemed to agree that it would have been impossible to meet such a target, as the housing subsidy scheme was extremely slow in beginning delivery. Hence, it was agreed to extend the 50,000 target for another year to July 1997. The government and the institutions agree that the 50,000 target was recently met; nearly R6 billion-worth[8] of lending has been unlocked in previously denied areas.

However, while the ROU has unlocked lending in previously denied areas, the interviews suggest widespread disenchantment with its achievements. The chief executive of the Council of South African Banks, says the ROU

> has perpetuated the same mistakes made prior to the agreement—that

> mortgage-backed loans are the most appropriate lending vehicle for the low-income housing market. The ROU was developed without taking heed of lessons financial institutions had learned from the previous lending environment: that you cannot take what is substantially a 'bad' loan and through 'fancy financial engineering' turn it into a 'good' loan.

Representatives of all the financial institutions, their organizing bodies and all but one of the government's initiatives now believe that mortgages cannot serve the needs of this category of people. The result of the previous decade, and in particular, the past three years, is not affordable mortgages, but overextended borrowers.

Focus Group Revelations

To assess this claim it is worth noting the findings of research (Tomlinson, 1996) by this author, carried out last year, on the views of beneficiaries of the housing subsidy on end-user financing as a way of improving their housing circumstances. A particularly significant theme in the focus group discussions was the gulf between the housing specialists' and stakeholders' perceptions of the importance of end-user financing and those of beneficiaries.

In sharp contrast to the housing debate's assumptions that the homeless do want greater access to mortgage loans, most focus group participants harbored a strong aversion to placing themselves at the mercy of commercial lenders. Among their reasons were: interest charges would make repayments prohibitive; and loans exposed households to repossession of their homes if they could not meet repayments. Rejecting a bank loan did not mean people had no plans to improve their housing; rather they wished to control their finances. The favored approach of those turning down the possibility of a loan was to buy materials they needed when they could afford this, and to effect improvements as they were able.[9]

These themes resonate with those advanced by the institutions today when questioned about their role as mortgage providers in this market. They argue that the term of a mortgage bond (20 years) is too long for a low-income household to sustain, given the instability of South Africa's economic climate. (The initiation of lending into the low-income market has on both occasions coincided with a severe downturn in the economy and consequent retrenchments, affecting the ability of many low-income bond holders to sustain their repayments.)

Furthermore, institutions feel a mortgage is too expensive for the low-income household, given the extreme volatility of the country's interest rates, which have risen between 12% and 22% during both the periods within which this lending has occurred. The complicated[10] nature of the lending product, given limited education and experience among new borrowers, often results in misunderstandings on the part of the borrower and consequent default.

BANKS AND BORROWERS AGREE

Hence, when asked about their experiences in lending under the ROU, the institutions and their organizing bodies—and all but one of the government's initiatives—note the use of pension or provident-backed mortgage lending, with or without the subsidy, has indeed allowed individuals to enter the low-income housing market for the first time. But many low-income borrowers (earning below R3,500 per month) who have accessed mortgage loans through this approach, have found themselves over-borrowed when their economic circumstances worsened. Unable to sustain their repayments, and with negligible equity[11] in the property, households have ended up finding both their house and pension or provident fund at risk. The issue, the financial institutions believe, has become not what housing consumers can realistically afford, but rather what they can qualify for.

In effect, it seems that both borrowers and banks are saying that a mortgage bond is an inappropriate lending instrument for this market because it denies borrowers control over their finances. The government should therefore question whether its policy of forcing[12] institutions to make mortgages available to low-income people is based on accurate assumptions about what financing low-income people require to house themselves.

REFERENCES

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NOTES

[1] The information for this paper is based on a five year research project, 'Evaluating and

Monitoring Housing Delivery Under the New Housing Subsidy Scheme,' which is being conducted by the Centre for Policy Studies, Johannesburg, and is partly funded by USAID. The paper was completed prior to Ms. Tomlinson's joining the Banking Council of South Africa.

[2] Non-traditional lenders, formally known as community-based retail lenders, were first established in the late 1980s to provide small loans to groups, rather than mortgage bonds for housing and other purposes.

[3] The Mortgage Indemnity Fund (MIF) was launched in June 1995 to encourage mortgage lenders to resume lending at scale, by providing cover against the risk that they would be unable to repossess properties due to a breakdown in law and order. SERVCON Housing Solutions was launched in June 1995 to address the problem of properties on which bond repayments had ceased. The National Housing Finance Corporation (NHFC) was launched in April 1996 as a development finance institution aimed at channeling funds to intermediaries which, in turn, grant loans to buyers of low-cost housing products or to institutions which provide housing on a rental or other tenure basis. NURCHA was launched in May 1995 to help housing development projects overcome barriers through a combination of capacity-building grants and bridging finance and loan guarantees.

[4] *Record of Understanding Between the Department of Housing and Association of Mortgage Lenders for a Resumption at Scale of Lending to Lower Income Borrowers*, 20/10/94.

[5] South Africa's new housing policy arose from a multi-party negotiating body, the National Housing Forum, made up of representatives of 'mass-based' political groupings, the business community, the building industry, the financial institutions and development organizations. Launched in August 1992, as a response to the then-government's racially based housing policy, the NHF was established as a vehicle for negotiating a new non-racial housing policy and strategy among key groups at a time when policy made unilaterally by the ruling National Party government was being automatically rejected.

[6] The magnitude of the housing problem—which was described at the time of the ANC coming to power as a backlog of 1.3 million units (rising to 3 million units, including hostels and rural areas) plus an additional annual requirement of 200,000 units for new family formation—would require a delivery rate of 300,000 units to reach the ANC's stated goal of 1 million units in its first five years of office.

[7] During the 1980s the housing market was unpacked into housing submarkets, namely conventional housing (assume R40,000 selling price); starter housing (assume R20,000 selling price); incremental/informal housing (assume R8,000 selling price for a serviced site—none available at that time).

[8] The institutions note, however, that their lending today is overwhelmingly in the conventional housing sub-market (R55,000 and above), and to households earning more than R3,500 per month (more than the maximum income level of the subsidy scheme) and with someone in formal employment. Hence, only one in five new mortgages is attached to the new subsidy scheme.

[9] A low-income housing consumer using formal developers and a mortgage bond receives as little as half as much value from his or her investment as when he constructs his house himself or uses small informal builders with funds from a series of small loans.

[10] The issue of compounded daily interest is rarely understood by borrowers, hence many of the bonds taken out over the previous decade are today owed more than when they were taken out.

[11] In an attempt to reach the ROU's 50,000 target, credit guidelines that eliminate the need for a deposit have also again ensured over-borrowed and under-secured borrowers. Banks would prefer a minimum 5% deposit, but as a result of government suasion, this criterion has been removed in order to bridge the affordability gaps.

[12] Small (micro) loans, offered by some of the institutions and a crop of new retail lenders, appear much more suitable to the needs of both the potential housing consumer and the lender. Without any government intervention, a market has developed around this lending instrument which is both manageable by the consumer and profitable for the lender.