The Role of the Banking Industry in Promoting Low-income Housing Development

by Mary R. Tomlinson

INTRODUCTION

Housing the nation is one of the greatest challenges facing South Africa's first democratically elected government. The extent of the challenge derives from the enormous size of the housing backlog and the desperation and impatience of the homeless to see results.

The availability and accessibility of credit for housing purposes has been identified by the South African government as a key cornerstone in a sustainable housing delivery process. However, a stable public environment conducive to attracting the necessary private investment, both of the household as well as that of the financial institutions, is required for viable private sector investment.

The issue for the banking industry is, therefore, not whether it has a role to play in the reconstruction and development of South Africa, but how that role should be carried out. With this is mind, housing finance initiatives have been designed to ensure that credit is extended at scale, in the shortest possible time frame through the mobilization of the major banks into the lower end of the market.

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FINANCING LOW-INCOME HOUSING DELIVERY

Nearly R172 billion in mortgage bonds, for both whites and blacks, make up 38% of the banking industry's total loans and advances; 250,000 of them (to the value of R11 billion) are in the black townships.

While the figure for black mortgage lending may seem relatively low (8% of the total), it reflects the fact that black people were legally prevented from owning property up until the mid-1980s. Legal restrictions, combined with extremely low affordability, has to date significantly affected the level of homeownership by the black population.

In addition, politically inspired bond boycotts, used as a weapon of "the struggle," led to an almost blanket exit of the financial institutions from what existed of the low-income housing market in the early 1990s. Considerable efforts have therefore gone in to turning this situation around.

THE RECORD OF UNDERSTANDING

A Record of Understanding (ROU)[1] between the Department of Housing (DOH) and the Association of Mortgage Lenders (AML) was concluded in October 1994 following negotiations aimed at creating a 'stable public environment' which would be conducive to the resumption and extension of lending to low-income borrowers.

The ROU was negotiated against a backdrop of discussions in the National Housing Forum (NHF)[2] on how to encourage the re-entry of financial institutions into the low-income housing market after their almost total exit from it in the early 1990s. Financial institutions insisted that their re-entry was being constrained by their inability to repossess a house when a homeowner defaulted on mortgage repayments.

The defaults may have been politically inspired, as with the bond boycotts which were being used as a weapon of 'the struggle,' or economically driven due to the worsening financial circumstances of the bondholder as the economy deteriorated and joblessness increased. In addition, households were apt to discontinue paying their mortgage bonds when they realized that they had purchased a shoddily constructed house.

The ROU was therefore necessary to break the deadlock that had grown up between government, the communities and the banks. Government agreed to launch a "vigorous and unprecedented national and provincial campaign" to persuade consumers to resume repayments and to reinstate law and order. The establishment of a Mortgage Indemnity Fund (MIF) would cover accredited lenders if they were unable, for political reasons, to repossess properties using the normal legal channels once default on the property had occurred.

Mortgage Indemnity Fund

In June 1995, the Mortgage Indemnity Fund was launched as a wholly government-owned company. It was viewed as an "interim" measure; i.e., the expectation was that it would only be necessary for three years until the repayment situation in the country was normalized. The MIF would be used to determine whether a previously redlined area was now safe to lend in, i.e., creditworthy. If upon examination the MIF determined that the area was sufficiently rehabilitated to resume lending in, then it would extend its cover against any 'political' risk the lender might experience. Under the MIF cover, the financial institutions were expected to provide 50,000 mortgage loans to low-income borrowers in the first year of the agreement.

To date, more than 90,000 mortgage loans valued at R7 billion have been covered by the Mortgage Indemnity Fund (MIF). While on the one hand this reflects significant lending into the township market, the expectation was that a much larger amount of lending would occur.

Moreover, in examining the lending figures, only 30% of it can be considered subsidy-linked lending. The rest is for households which would not be considered low-income in the strict sense of the definition, i.e., the household income is above R3,500 per month ($729). Hence, any disappointment in the lending figures reflects the fact that mortgage lending has not penetrated the subsidy-linked market as much as hoped for. On the other hand, there is no doubt that this lending simply would not have occurred without the MIF.

SERVCON Housing Solutions

In addition to the MIF, a range of related institutions was established during this period. SERVCON Housing Solutions was launched in June 1995 as a joint venture between government and the Council of South African Banks (COSAB) to address the problem of properties on which bond repayments had ceased There are close to 35,000 of them at the present time.

SERVCON was set up to deal with the properties that had been repossessed by the banks (PIPs, i.e., properties-in-possession) after a sale in execution but which the banks were unable to repossess due to the breakdown of the due process of law. Close to 14,000 properties were to be visited by SERVCON employees to offer the households various options, such as rehabilitating their mortgage bond or moving to accommodations more in line with what they could afford—"right-sizing."

In addition, the banks had another approximately 18,000 non-performing loans on their books which they were unable to deal with. It was, therefore, agreed that SERVCON would assist with these loans as well.

Presently, there are approximately 34,000 non-performing housing loans with a value exceeding R1.6 billion. In situations where bondholders have defaulted on their loans but have remained in the property, they frequently default on their local authority service payments or fail to carry out necessary maintenance on the property. Banks have, therefore, been forced to carry the costs of the former—in some cases for more than eight years—which amount to hundreds of millions of Rands per year.

Home Builders Registration Council

In addition to the need to deal with the default situation, banks felt it necessary to address the problems of shoddy workmanship that are part and parcel of the low-income housing market. In the minds of many low-income mortgage bondholders, it was the banks, rather than the developers/contractors, who were responsible for repairing the poorly constructed houses they had purchased. Until such time as repairs were carried out, householders would simply stop paying their mortgage bond instalments.

A Home Builders Registration Council (NHBRC) was launched in June 1995 to register the builders operating in the low-income housing market. Builders are to register with the Council and then build houses in line with standards it sets down. In a case of shoddy workmanship, and where builders do not honor their warranty, homeowners are able to approach the NHBRC for assistance. Builders pay a warranty levy of 1.3% of the total contract price to the NHBRC for this purpose.

Due to the difficulty with cash flow experienced by emerging builders, the banks have agreed to pay this levy to the NHBRC up-front on the builder's behalf. The levy is then deducted from the first tranche of payments made to the builder.

Revising the ROU

After nearly three years in existence, the MIF terminated at the end of March 1998. To date, there has been very little success in normalizing the housing environment: SERVCON still holds nearly 36,000 non-performing loans on its books, valued at R1.6 billion. The lack of success in normalizing the situation is the result of economic hardship combined with the breakdown in the criminal justice system, which prevents banks from realizing their security.

Nevertheless, SERVCON will continue its work with the non-performing portfolio. Moreover, the banks and government will continue working together to increase viable, sustainable lending in the low-income housing market.

APPROPRIATENESS OF MORTGAGE BONDS TO THE LOW-INCOME MARKET

At the time of the establishment of the above-mentioned institutions, it was often remarked that there was far too much focus being placed on conventional mortgage bonds as the most appropriate (or perhaps even the only) form of credit for the low-income market. The reason for this situation arose from the fact that the housing subsidy, negotiated at the NHF, only offered a limited capital subsidy to each qualifying household.

The government's new housing subsidy is a once-off capital grant, with the level of subsidy varying according to household income.[3] The smaller subsidies go to households in the higher income groups. Housing commentators and potential beneficiaries have voiced the opinion that the subsidy amount is too low to acquire a four-room house—as promised by the politicians in the run-up to the 1994 election—but rather is only able to cover the cost of a 'progressive' housing product, e.g., a serviced site and a small rudimentary starter house. A key element of the overall deal negotiated at the NHF was, therefore, the availability of mortgage finance to extend the housing subsidy to be able to cover the cost of building a four-room house. More specifically, a very small conventional house on a serviced site costs approximately R45,000 to erect. A household will require a monthly income of not less than R2,800 per month to cover the monthly mortgage bond instalments (20-year term, 19% interest rate). However, according to official statistics, fewer than 6% of South African households fall into the low-income category of R2,500—R3,500 per month and can therefore afford to purchase a house using a mortgage bond and the government subsidy. Nearly 80% of households earn less than R2,500 per month, which is too low for the housing products on offer.

Significantly more households, nearly 42% of them, can afford a small 'micro' loan. A 'micro' loan is a short- to medium-term loan of between R6,000 and R20,000. These small loans are used for a variety of purposes, including bridging the gap between the government's housing subsidy and the final cost of a house.

In order to qualify for a 'micro' loan the borrower must be formally employed so that the repayments can be collected through a payroll deduction facility. In addition, he/she must secure the loan with his/her pension or provident fund.

Currently, the banks hold approximately 322,000 'micro' loans. This results in an additional R2.7 billion of lending by the banks into the low-income market.

Alternative Lenders

For a variety of reasons, banks have not proved as effective as they would like at doing business in the lower income categories of the formal economy. One of the main reasons for this situation is that the financial returns for doing business in this sector do not compensate for the increased risk and costs involved.

Interest compensates the lender for the cost of the money, for the risk that the lender takes on, and for the cost of granting and administering the loan. The administrative cost is related to work that will have to be carried out by the lender and is not related to the amount of the loan; administration can be the same for a small as a large loan, or even greater.

For loans in excess of R6,000, banks are constrained by the provisions of the Usury Act,[4] which places a ceiling on the rate of interest that can be charged. Because the Usury Act does not take the administration cost of a loan into consideration, or cater adequately for the higher risk, its effect has been to limit bank lending in the low-income market.

This situation has resulted in the creation of non-bank lenders. A non-bank lender is not governed by the Banks Act, nor can it take deposits. Currently, there are approximately 15 formal non-bank lending institutions that make 'micro' loans available to low-income borrowers.

These small 'micro' lenders generally offer loans of less than R6,000; in this way they avoid the Usury Act. Consequently, they are able to charge rates that satisfactorily cover the risk and the cost of doing business in this market. Noteworthy is the fact that much of their capital comes from both private and public sector donors, which also reduces their costs.

OTHER FINANCIAL INITIATIVES FOR THE LOW-INCOME MARKET

The difficulties described above in extending credit into the low-income market have necessitated the creation of further government development finance institutions (DFIs), in particular, the National Housing Finance Corporation (NHFC) and the National Urban Reconstruction and Housing Agency (NURCHA).

Development finance institutions will make funds available for on-lending to what are termed retail finance institutions. These intermediaries—banks, non-bank lenders and other organizations—will borrow from the DFIs and lend to the person in the street, generally through the previously described payroll deducted, micro-loan.

National Housing Finance Corporation

The National Housing Finance Corporation is a public company, established by the government in May 1996 as a development finance institution. The government is the sole equity investor, although 24 private investors, including pension funds, hold secondary capital in the form of convertible debentures.

The corporation operates on market principles, for example, by pricing its money at market-related rates. It aims to seek new and better ways to mobilize housing finance to create housing opportunities for low- and moderate-income families. The NHFC functions essentially as a wholesale financier, by taking investments from contractual savings institutions and directing finance and other assistance to intermediaries serving the low-income housing market.

Since its inception the NHFC has approved loans to its intermediaries of approximately R420 million, of which it has disbursed R260 million. These facilities have benefited close to 60,000 families.

As part of the Revised ROU, the banks have undertaken to work with the NHFC and Department of Housing to explore ways in which risk can be shared, leading to increased lending.

National Urban Reconstruction and Housing Agency (NURCHA)

The National Urban Reconstruction and Housing Agency is a not-for-profit (section 21) company, established in May 1995 as a Presidential Lead Project to facilitate access to finance for subsidy-linked housing projects. It shares financial risk—as opposed to guaranteeing political risk like the MIF—with financial institutions and housing developers. It does this in order to encourage low-income housing development. NURCHA's task is, therefore, to identify and eradicate obstacles to the viable delivery of low-income housing, for example, through the provision of capacity-building grants, bridging finance and loan guarantees.

To date, NURCHA has supported the financing of 19,424 houses with guarantees valued at R23,389,003. In addition it has provided R7,332,799 in working capital for the facilitation of housing projects.

MORTGAGE LOANS TO PUBLIC SECTOR EMPLOYEES

For a number of years public sector employees' affordability has been calculated on the basis of their monthly instalments, which were allowed to equal 25% of their monthly income, plus the addition of their employer housing subsidy. In comparison, private sector employees affordability has been calculated on the basis of adding together their monthly income plus their employer housing subsidy and taking 25% of the total amount.

This different application of credit guidelines has resulted in public sector employees being able to purchase a much more expensive house than their private sector counterparts; i.e., a much higher percentage (+45%) of their income ends up being committed to repaying their bond. Moreover, the public sector employees have been able to take out a mortgage bond for 100% of the purchase price of the house, using their pension fund as security, while the private sector employees have been required to put down a 20% deposit.

This situation, combined with the fact that in the current economic climate public sector employees are being exposed to high levels of retrenchment, moved government to equalize the lending criteria. As of March 1, 1998, the concession began being phased out with the intention to fully subject public sector employees to the same guidelines as other employees by November 1, 1998.

COMMUNITY REINVESTMENT LEGISLATION

In the light of the enormous need for reconstruction and development of both the society and the economy, and the role of finance in reaching this goal, debates have begun surfacing about the need for a piece of legislation, along the lines of the United States' Community Reinvestment Act, to ensure that funds are available to the communities that require them.

On the one hand, initial investigation has revealed that such legislation presents an opportunity for financial institutions to become involved in their communities. On the other hand, significant differences exist between the U.S. and South Africa so as to make the legislation in its American form not wholly appropriate to the South African situation. For example, those in need of resources form a minority in the U.S., while in South Africa they form an overwhelming majority. Nevertheless, the principles underpinning such legislation as well as how best to apply it is currently being thoroughly examined by government and the banking community.

CAPITAL ADEQUACY REQUIREMENTS ON HOUSING LOANS

There has been a trend in recent years to grant mortgage loans for an increasingly higher percentage of the value of the mortgage property. This is in contrast to the international experience that indicates that the lower the percentage stake the home-owner has in the property, the easier it is for him/her to walk away from it. This situation of granting large loans relative to the value of the underlying security is one of the reasons for a trend towards increasing losses in the mortgage-lending of the banks. Nearly R6.7 billion (or 43%) of the banks R16 billion non-performing loans in December 1997 related to housing.

In response to this trend of making higher-risk mortgage loans available in the market, the Registrar of Banks has indicated that from the middle of 1998 the existing concession of a 50% capital weighting on all residential mortgage loans will be withdrawn to the extent that those loans are in excess of 80% of the value of the property. The capital requirement on the portion of the loans exceeding 80% of the property value will be doubled from 4% to 8%. This is likely to result in an increase charged on mortgages which exceed 80% of the property value.

EXPENSE AND COST RATIOS

The total expenses of the banks for 1997 (including R3.5 billion of bad debt provision) amounted to R25 billion. The gross income of the banks was R33 billion. The ratio of costs (excluding the bad debt provision) to gross income, which is commonly referred to as the 'cost ratio,' is critical to banks, as it indicates how much of their income is being consumed by operating expenses.

Lower cost ratios mean greater cost-efficiency and the ability to offer better service at lower prices and more attractive interest rates to clients. In a recent 1997 Banking Survey for Africa, the auditing firm of KPMG made the following comment about the cost ratios of the South African Banks:

> "Why do South African banks have wide margins and high cost structures? Partly because of a wide business spread over a full spectrum of products (while home loans have low margins, vehicle financing requires very high margins to allow for the high bad debts), lack of economies of scale, higher taxes and levies, wide geographical spread with large branch networks, high costs relating to a drive for non-interest income, massive security costs to cope with bank robberies, fraud, etc. Foreign banks could be surprised by the cost of doing business in South Africa, coping with inefficient telecommunications and generally poorly educated staff."

Whatever the cause, the fact of the matter is that the South African banks are for the most part operating at high cost ratios by international standards.

TECHNOLOGY

Recognizing the need to extend banking services to low-income earners nation-wide, the major banks have made massive investments in technological infrastructure. The latest technologies have been employed in providing these services, and it is not surprising that the international banking community now regards South African banks as world leaders in the provision of appropriate banking services for low-income communities. Moreover, since the 1994 democratic election, the banks have played a key role in black empowerment transactions; some R8.2 billion in transactions have been carried out.

THE BANKING COUNCIL AND THE WAY FORWARD

Surveys of the needs of low-income people continually reveal that adequate housing is a very high priority. At the same time, it is clearly the case that mortgage lending can make good business sense for the banks only if bonds are repaid. Hence, both government and the banks are concerned with addressing the problems that have obstructed lending in this market.

Notwithstanding this, it is incorrect to assume that by intervening in the marketplace it is possible to get banks to behave significantly differently from the way they would operate under normal lending conditions. Banks are concerned that much of the lending they have carried out to date has been due to significant government pressure based on sociological and political, rather than economic, reasons.

The Banking Council has recently established a dedicated housing team to carry out timely research on innovative approaches to providing finance for this market; to lobby key housing stakeholders with respect to the banks position on issues; and negotiate agreements between the banks and government on the environment in which the banks must operate.

The Banking Council will, therefore, continue to explore appropriate options for this market while ensuring that the banks are able to conduct their business competitively, profitably and responsibly.

NOTES

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

[2] The National Housing Forum was a multi-party negotiating body made up of representatives of 'mass-based' political groupings,

banks, business, building industry and development organizations.

[3] Initially there were three subsidy amounts—R12,500, R9,500 and R5,000, for income levels of up to R1,500, R2,500 and R3,500 per month, respectively. Subsequently, the subsidy amount was changed for households earning up to R1,500 per month to R15,000.

[4] Loans of less than R6,000 are exempt from the Usury Act; however, banks are not equipped to grant such small loans, nor are they keen to charge low-income borrowers extremely high interest.