Ensuring Mortgage Repayment in South Africa

by Mary R. Tomlinson

BACKGROUND

One of the most challenging and yet most intractable problems facing South Africa's first democratic government is the failure of many township residents to pay their rates and service charges and mortgage bonds (loans). Whether this is due to economic problems, dissatisfaction with the house or political reasons, the result is that South Africa's financial institutions currently have 31,000 non-performing loans on their books.[1]

There was considerable optimism during the days following the signing of the *Record of Understanding* of October 1994 between the Department of Housing and the Association of Mortgage Lenders.[2] Under this accord, the department undertook to create a "stable public environment" conducive to the resumption of lending to low-income borrowers. However, the fact that these problems have still not been resolved is a cause for concern.

The non-payment of installments on privately held mortgage bonds as well as charges for publicly provided services[3] is a threat to the new democratic order for three reasons. First, it weakens the financial system as banks become burdened with an extraordinary number of non-performing loans.

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Second, as long as urban services are not funded by consumers' payments, the funding base of the cities, where much of the country's economic activity occurs, will be fragile; and this will increasingly threaten the viability of the society and the economy.

Third, by not meeting their obligations to honor their financial commitments, citizens are reneging on their part of the "social contract," which is a pillar of any democratic society.

Until now, repeated attempts to address this problem—or even to understand it—have largely failed. However, the views of representatives of the financial sector are not uniform. Some feel a gradual process of procedural reform, combined with better management practices and a more understanding treatment of defaulters, will turn the tide.

Others feel that the "rule of law" has collapsed and that the hard-core areas in which people refuse to pay on principle are setting an example which can spread like wildfire across the country.

What is the crux of the problem? Is it, as many claim, the government's failure to create an appropriate environment to ensure the "rule of law"? Or have pressures to extend mortgage finance to low-income borrowers resulted in economically fragile households being persuaded to take on a bigger financial commitment than they can handle?

This paper, part of a continuing attempt to monitor housing policy and draw out the lessons of past experience for future strategy, seeks to address these questions by examining how housing finance stakeholders—lenders, the law firms that work with them, and sheriffs who carry out evictions—view their experiences of the past few years.

WHY DON'T PEOPLE PAY?

An important first step in addressing the nonpayment situation is to understand why people do not pay. To this end, interviews were conducted with representatives of financial institutions and the Home Loan Guarantee Company (HLGC).[4] Their responses indicate that by far the most common reason why people stop paying their bond installments is that they can no longer afford them. This is followed, in descending order, by dissatisfaction over poorly built houses; an insufficient understanding of loan conditions; and political considerations.

Problems of Affordability

Since the late 1980s, enormous pressure has been placed on financial institutions to make mortgage finance available to low-income households; as a result, nearly 250,000 mortgage loans have been extended to township dwellers.

Affordability is a major issue for all South Africans, particularly low-income households. Today, one needs, at minimum R3,500 per month ($583) to pay for a bond of R875 per month. This would purchase the cheapest conventional house—fully finished and serviced—costing around R50,000 ($8,333).

The typical maximum income-to-price ratio is 30% joint household income, but often the actual ratio exceeds this limit. The typical term of the mortgage bond (loan) is generally 20 years, with a variable interest rate. In the old days, building societies provided a mortgage bond with a strict loan-to-value (LTV) ratio of 25%. Today most people use the banks for their loans, and the loan-to-value ratios have become distinctly less strict. A 75% LTV is typical and in many cases can rise up to 100%.

Despite this liberalization, it is almost impossible for the black population to come up with a downpayment of 25%; much "fancy financial engineering" has been applied to enable them to bridge affordability gaps. Most of these loans have, at most, a 5% deposit, with the use of pension and provident fund benefits, and the purchase of deposit-replacement insurance to guarantee the other 15%.

The consequence of this is that many township borrowers quickly become over-extended when their economic circumstances worsen; they are highly vulnerable to increases in interest rates.[5]

Product Defects

Because of a lack of quality control in the building industry, some low-cost houses have been very poorly built. According to the research, "dissatisfaction with housing products" is often at the nub of a low-income household's decision to stop paying its mortgage bond.

Unlike the more sophisticated suburban homeowners, first time black home buyers do not understand that the quality of the product is the developer's responsibility and not that of the banks. They assume that, when a bank's assessor inspects a new house, he or she is certifying its quality; they do not understand that the bank is simply checking to ensure that the house is equal to or higher than the value of the bond.

Insufficient Understanding of Loan Conditions

Mortgage bonds are complicated lending instruments for low-income households to understand and manage. Given their limited education and experience, and the often inadequate borrower education provided by financial institutions, many borrowers end up misunderstanding the extent of their financial commitment.

Moreover, when they experience economic hardship they are totally unable to protect themselves from the severe financial consequences of missing monthly installments. That is, they will either have to extend the terms of their loan, which results in a much larger total amount that is repaid over the life of the bond, or else they will simply default on the loan.

Political Problems

As previously described, communities can be mobilized by their various leaders to stop paying their services, and sometimes their mortgage bonds, as a form of political protest. Bond boycotts, or more often the threat of them, and group action at the street and neighborhood level has dogged the lending environment since the late 1980s. Consequently, while many attempts have been made to establish why people don't pay, the greater problem lies in the actions they resort to when a bank moves to repossess a house.

WHAT LESSONS HAVE WE LEARNED?

The interviews were aimed at revealing lessons, based on the experiences of key stakeholders operating in this environment, that could be used to turn the non-repayment situation around. These lessons fall into three separate categories, including:

- the default process;
- the market; and
- consumer education.

The Default Process

Key to understanding the repayment problems in the country is a thorough understanding of the process a household goes through from the point of default, through to eviction and repossession of a house.

In general banks move very quickly if a borrower gets into arrears. Most banks try to contact the client personally as soon as one payment is missed. Where this is not possible, the bank will try to contact them by post. It is no longer the initial intention of the banks to repossess a house. Rather, experience has proven that it is best to try and work with the client to rehabilitate the situation as quickly as possible. Only when the bank is convinced that there is no hope of rehabilitating the situation will it move to take legal action.

At this stage the bank turns the case over to its attorneys, and the process becomes fairly mechanical. A summons is prepared which is issued by the court and served by the sheriff. If no defense is entered by the client within five days, as is typically the case, then the attorneys will lodge an application for a default judgment. Parallel to obtaining the judgment against the client, the bank will also obtain an order declaring the property executable, which means it can be sold to satisfy the debt. Often the sole bidder is the bank that lent the money in the first place, with the property being bought in by the bank as a property-in-possession (PIP).

Just as important as buying back the house is being able to obtain vacant possession from the tenant. Invariably this is not easy. In cases where the tenants refuse to vacate the premises the court will grant a warrant of ejection which the sheriff serves.

However, often the tenants still refuse to vacate the premises. In many instances the community will demonstrate its support for the tenants. It is therefore not uncommon for the sheriff and his team to be subjected to threats and abuse.

If the eviction is carried out, it is then the responsibility of the bank to ensure that it is not re-occupied. Locks will be changed, and a security guard may be placed on the property. Experience has proven, however, that these steps are often inadequate to prevent the property being illegally re-occupied, often by the previous tenants using force. This action, in effect, negates the action of the court procedures that have led up to the eviction.

In well-documented situations, such as Motherwell in the Eastern Cape, the situation has become so bad that no action to evict is being taken any longer. This is because in cases where successful foreclosures and evictions have occurred, the community has responded by demolishing the house.

Hence, it is at this precise point in the process that the "rule of law" breaks down. It is here that government must show its commitment to ensuring that the rulings handed down by the courts are carried out. The only option left open to the banks, once the house has been re-entered, is that of laying a charge of trespass. However, trespass is not normally considered a serious crime, either by the police or the courts.

But if the impact of this continual inability to gain vacant possession is having a serious impact on the banking and housing sectors, and the country as a whole, then the Justice Department should take the matter much more seriously. This could take the form of informing prosecutors to deal more vigorously with the issue, which could mean more focused assistance may be required to handle the case load.

The Market

A major flaw revealed in the research is the fact that there is no secondary market in the low-income housing sector that can enable defaulting mortgagors to sell their property prior to a sale-in-execution. As a sale-in-execution generally brings in a rock bottom price for the house, the incentive to sell it into a normal market situation is that the price received should be higher than what is available through auction.

Moreover, from the financial institution's view, this lack of a secondary market compounds its problems in being able to dispose of the property once it has repossessed it. Research has revealed that third parties are very reluctant to purchase township PIPs for a number of reasons, including the fact that the community often exerts strong pressure, especially in areas that have been hit by serious levels of unemployment, against any new person who attempts to buy the house of a defaulter.

It is critical that communities begin to understand the benefits of a functioning secondary housing market. Various measures should therefore be considered to establish such a market. The most important of these, however, consists of being able to guarantee that the property will remain vacant once it has been sold. Other measures suggested by the research include:

Condition of sale. One major obstacle to the purchasing of repossessed houses is that the new buyer must pay the outstanding rates and service charges. This results from the fact that local authorities, as covered in the provincial ordinances, have a preferential status in the reclaiming of these arrears. Houses may only be transferred in the Deeds Office once a clearance certificate from the local authority has been obtained.

Where the real crunch comes is in the fact that in recent years local authorities have been derelict in recovering the charges that have been owed to them. This being the case, the banks have had to pay enormous outstanding amounts when they have gone to buy-in the properties that secure the defaulted bond. Some of these outstanding charges are then tacked onto the purchase price of the house.

It would, therefore, appear to be in everyone's interest to develop a policy to deal with a situation that arose during "the struggle" but is still having negative repercussions today.

Housing defects. The problems of defective new housing should begin to lessen with the recent passage of the National Home Builders Registration Act. The provision of a warranty scheme will, for the first time, provide homeowners with recourse when problems develop. Moreover, potential homeowners need to be informed of the precise role the assessor plays in inspecting the house being purchased.

Consumer Education

The assumption that low-income households are able to understand and manage mortgage bonds is proving to be seriously flawed. The experience of operating in this market over the previous 10 years has revealed that potential borrowers never realize what an onerous and costly lending instrument a mortgage bond is. Consequently, without adequate financial counseling and consumer education, it is extremely easy for low-income, first-time home buyers to get in way over their heads.

Households need to have precise information about the various types of available lending instruments, e.g., mortgage bonds and micro loans. Lenders should therefore provide them with a clear understanding as to the cost and commitment required by these forms of lending, and in particular, the potential for additional costs if they get into trouble.

Banks, moreover, should refrain from lending to a household's maximum affordability. This recommendation is made based on the fact that South Africa's economy is extremely volatile. This results in periodic spikes in the inflation rate that throw out assessments of affordability. This being the case, households need to have a margin of error in case interest rates rise.

CONCLUSION

This research has substantiated the claim that government has failed to normalize the lending environment by not ensuring that the "rule of law" is carried out.

At the same time, it is clearly the case that mortgage bonds, more often in recent years provided at the insistence of government for socio-political reasons, can become a "noose around the neck" of low-income households. Both the banks and government are now saddled with a mess.

A two-pronged approach, in which the banks and government work together, is therefore necessary to sort out this situation. Under the Revised Record of Understanding, Servcon, a joint venture between the government and the banks created to tackle the problem of the 31,000 non-performing loans (NPLs)—known as the "ring-fenced" book—must be made to succeed.

A generous package of options has been developed whereby households are eased back into repaying their bonds or move into more affordable accommodation.[6] Where households are not prepared to take up one of the Servcon options, either due to a total loss of income or simply a refusal to pay anything, then the system for evictions must be made to work.

More important is what is done in the future. The result of banks' viewing mortgage lending as a competitive issue is that in order to attract customers some commonsense lending "rules of thumb," such as the need for downpayments and not letting monthly repayments climb beyond a safe maximum, are forgotten.

Failing some type of regulated lending criteria, the best way to counteract this situation is through on-going, focused consumer education emanating from a variety of directions—e.g., the banks, government, consumer groups and so on. Only through such an effort will people become financially sophisticated enough to effectively manage their own finances.

NOTES

[1] This represents 12.4% of the approximately 250,000 loans made on townships beginning in the late 1980s. The normal definition of default is three months or more in arrears.

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

[3] Taylor, H. and Mattes, R., "Evaluation of and Demands on Local Government." IDASA, *Public Opinion Service POS Report, No. 3,* Cape Town, February 1998.

[4] Home Loan Guarantee Company was established in 1989 to provide guarantees to banks and building societies. The guarantee was aimed at reducing the risk banks perceived they were faced with in lending to the low-income market.

[5] For a description of problems in delivering housing finance to low-income people, see Tomlinson, M.R., "Mortgage Bondage? South Africa's Financial Institutions and Low-Cost Housing Delivery," *Housing Finance International,* Vol. 12, No. 4, June 1998.

[6] Servcon has started a "right sizing" program in which households can move to more affordable accommodation (owned by Servcon) if they cannot afford the house they purchased.