



**THE NATIONAL CREDIT ACT AND ITS
REGULATIONS IN THE CONTEXT OF
ACCESS TO FINANCE IN SOUTH AFRICA**

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November 2006

Prepared for FinMark Trust, South Africa

Acknowledgements and authorship

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The report draws on an earlier unpublished report completed for FinMark Trust by Dr HB Falkena and Prof H Schierenbeck in May 2005 while the National Credit Act was still being promulgated. Brigit Helms of CGAP also provided guidance and input. Their inputs are gratefully acknowledged.

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GLOSSARY

APRC	Annual percentage rate of change
APR	Annual percentage rate
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CGAP	Consultative Group to Assist the Poor
Dti	Department of Trade and Industry (South Africa)
EU	European Union
LSM	Living Standards Measure
MFRC	Micro Finance Regulatory Council of South Africa.
MFI	Micro finance Institutions
NGOs	Non-governmental organisations
SMEs	Small and medium enterprises
TCOC	Total cost of credit
UMOA	Union Monétaire Ouest Africaine (Monetary Union of West Africa)
UK DTI	The UK's Department of Trade and Industry

EXECUTIVE SUMMARY

With its National Credit Act (2005) and Regulations (2006) the South African government is moving aggressively against predatory lending, consumer abuses and outdated, piecemeal and ineffective legislation on consumer credit.

This paper analyses the potential impact of this Act and its regulations on access to all forms of financial services.

The South African financial sector is complex, comprising both a highly developed formal sector and an informal financial market serving about 85% of the population¹. As the National Credit Regulator starts work, the need to understand how this legislation will affect access to finance is critical.

The main conclusions of this analysis are:

1. The new law and regulations, initiated by the Department of Trade and Industry (dti), were designed to solve specific problems in the consumer credit market (only credit-related issues are within dti's mandate), including the high cost of credit. They were not designed to address the broader issue of increasing access to finance.

The problems identified by dti in 2003² included reckless behaviour by credit providers; exploitation of consumers by some microlenders, debt administrators and debt collectors; lending without regard for a borrower's ability to repay, leading to high levels of indebtedness; deceptive pricing; and abusive collection techniques. To solve these problems the dti is establishing the National Credit Regulator and a National Consumer Tribunal; registering all credit providers; registering debt counsellors to help customers who are over-indebted; and creating categories of interest rate caps.

2. The National Credit Act brings South Africa's credit legislation on par with similar legislation in developed countries. It is likely to reduce undesirable credit practices significantly, but it may take some time for the financial system to adjust and then expand under the new law. The National Credit Regulator is tasked with reporting on progress in developing the credit market, but the sector would also benefit from an independent assessment of whether access to credit has improved from the perspective of the client

1 Technical Committee, Credit Law Review, dti 2003

2 Summary of the Findings of the Technical Committee, Credit Law Review, dti 2003.

The new law advances mainstream prudent lenders and responsible borrowers of all income levels. If formal lenders can take on board these responsible borrowers from the informal market, the new law will reduce the grey market. The new law also tries to remove obstacles to medium, small and micro credit, which were contained in the now repealed Usury Act. The extreme default risk in the credit market (a relatively small number of borrowers, but with major cost consequences for other parties) should also reduce, which should benefit all participants, except loan sharks. It would be useful if an independent research group assessed access to credit from the perspective of clients to complement the reports of the Regulator on his own work. This is consistent with the Financial Sector Charter aims of monitoring access to finance and implementing mechanisms to review the impact of its initiatives on access.

3. The impact of the law will be quite far-reaching, and the danger exists that policymakers will underestimate the magnitude of these regulatory changes. During the introduction phase of the new regulatory regime, the authorities should be helpful and even generous to the microlending industry and banks as they adjust to new competitive conditions.

Banks will now have to contend with an additional regulator. A banking group with a diversified product offering will have three regulators: the SA Reserve Bank, the Financial Services Board and the National Credit Regulator. It is important that the regulators cooperate to streamline and agree their requirements to prevent an unreasonable supervisory reporting burden.

4. International experience in both developed and developing financial systems shows that price controls are not an optimal mechanism for managing the problem of the high costs of credit. The reckless lending and disclosure regulations, together with the transparency rulings of the National Credit Regulator, should be enough to promote competition and bring rates down. Early removal of the price controls is urged.

The UK Department of Trade and Industry assessed the effect of interest rate caps on both access and the pricing of credit for low-income groups in the United States and three European countries: the UK, France, and Germany. It found much lower observed credit use among low-income households in markets with ceilings, and attributed this to constrained credit options rather than lack of demand. In developing economies with interest rate ceilings, it is difficult or impossible for formal and semi-formal microlenders to cover their costs, driving them out of the market, or keeping them from entering in the first place. Evidence shows that competition is the single most effective way to reduce both

microcredit costs and interest rates. In many competitive markets, efficiency has improved and microcredit interest rates have declined³.

5. Other laws introduced in recent years, such as the National Payment System Amendment Act of 2004, as well as others being drafted, are critical to expanding access to financial services, and their introduction should be speeded up.

The National Payment System Act was amended in 2004 by the National Payment System Amendment Act in an attempt to force the four tier-one banks to relinquish their monopoly of the national payments system so that tier-two and tier-three banks can also participate, which is critical for access to savings. The tier-one banks' cartel is highly detrimental to the small saver, creating high barriers to savings services. Creating a possible Deposit Insurance Act, which is receiving attention from the Minister of Finance at present, to protect small savers, and the Banks Act of 1990, which addresses nearly all deposit-taking institutions, are also important for expanding access. These would benefit from an independent light being shone on them to illuminate how they affect access to finance.

6. Debt counsellors will provide important social support, but preventing over-indebtedness is equally as important as solving the problem after the fact. Public education campaigns to promote saving, and financial literacy training are ways to prevent over-indebtedness.

Debt counsellors, if effective, will be important to over-indebted individuals (24% of the sample households in the Financial Diaries project). But financial literacy and promotion of savings, to prevent the problem before it happens, are equally as important in the long term, though not all within the mandate of dti. The Financial Services Board's national strategy on financial literacy needs to include promoting savings for the public good. (The banks might want to promote consumer education as well, since it is in their interest.) The financial sector needs to prioritise expanding access to saving.

7. The broader challenge of access to a wide range of financial services, including savings and insurance, for the majority of the population remains. An interdepartmental body and/or an independent research group should be commissioned to track the performance of all laws affecting this issue and should make recommendations not only to dti but also to the National Treasury, the SA Reserve Bank, the Financial Services Board, and other relevant agencies.

³ Helms and Reille, 2004

An annual report by the National Credit Regulator on access to credit is inadequate to examine the effects of the new regulations on access to all types of financial services. An interdepartmental body and/or independent research group needs to track the effects of the regulations on access to financial services and make recommendations consistent with the Financial Sector Charter commitment of substantially increasing effective access to first-order retail financial services.

1. INTRODUCTION

1.1. Issues that led to a National Credit Act in South Africa

The Department of Trade and Industry in South Africa is responsible for overseeing the credit market. Its policy objectives are “the promotion of a stable, efficient and competitive credit market in which consumers’ rights are adequately protected, and in which access to finance [i.e. credit] is improved, particularly for development purposes”. (dti 2003 p.4)

The need for a review of the consumer credit legislation had been recognised since the South African Law Reform Commission’s 1994 review of the now repealed Usury Act 73 of 1968. Subsequent reports have commented on the weaknesses in consumer credit legislation. These include the Strauss Report on Rural Finance;⁴ the National Small Business Regulatory Review by Ntsika Enterprises Promotion Agency in 1999, and the Policy Board for Financial Services and Regulation’s report on SMEs Access to Finance in South Africa, 2001.

South African consumer credit legislation previously consisted principally of the Usury Act; the Credit Agreements Act 74 of 1980 (hereafter “the Credit Agreements Act”); and the Exemption Notices, 1992 and 1999. A range of political, social and economic changes have influenced the consumer credit market since 1968. These have coincided with major technological advances. Criticism of a dysfunctional credit market was based on the following problem areas:

- Fragmented and outdated legislation;
- Ineffective consumer protection, particularly in relation to the 85% of the population in low-income groups;
- High cost of credit and, for some areas, lack of access to credit;
- Rising levels of over-indebtedness; and
- Reckless behaviour by credit providers and exploitation of consumers by microlenders, intermediaries, debt collectors and debt administrators. (dti, RSA Credit Law Review Introduction page 2 Feb 2004)

The dti has addressed specific problems, such as increasing the protection on microloans, but the approach had been piecemeal. In 2002 concerns were rising about credit markets, and credit market legislation, specifically:

⁴ See the Final Report of the South African Law Reform Commission: *Inquiry into the Provisions of Rural Financial Services* RP 108/96 which was published on 18 September 1996.

- Increasing concerns by consumer representatives about the effectiveness of consumer protection, particularly of low-income consumers;
- Access to finance (ie credit) remained a problem. This affected small and micro businesses, and hindered progress in important parts of the national economic transformation and development strategy;
- Increasing concern about the level of indebtedness;
- Mounting evidence of reckless behaviour by credit providers, and exploitation of consumers by microlenders, intermediaries, debt administrators and debt collectors; at the same time banks and other credit providers were finding that inappropriate legislation curtailed innovation and prevented them from serving the housing and SMEs market, as well as the low-income personal finance market; and
- The collapse of large microlenders such as Unibank and Saambou highlighted underlying problems in the market and indicated that some regulatory problems may even introduce systemic risk. (dti 2003 p. 4)

Inappropriate legislation, whether the Usury Act, Credit Agreements Act or debt collection procedures in the Magistrates' Courts Act 32 of 1944, and a lack of enforcement, all contributed to the unacceptable state of affairs. Together with the increasing use of credit by low-income consumers came an urgent need for a closer examination of the credit legislation.

The dti set up a technical committee to undertake a credit law review in 2004, with the mandate to examine these problems. The review was co-ordinated by the Micro Finance Regulatory Council of South Africa (MFRC).

The dti has a mandate to oversee only the credit market: it has no broader mandate. It could not include savings or any other financial service in this review. The closely related issues of access to other financial services, such as small balance deposits, were therefore never considered by the committee. As borrowing and savings are two sides of the same coin this was problematic. Repaying a loan is a form of saving, or to use the terminology of Rutherford (2001), borrowing is "saving down" and deposit services are "saving up". Many poor people are simply too poor to engage in "saving down" and moreover risk averse and therefore prefer to "save up".

1.2. Credit market weaknesses identified by the 2004 committee

- Inadequate rules on disclosing the cost of credit. This means that, through the inclusion of a variety of fees and charges (including excessive credit life insurance), the cost of credit is regularly inflated above the disclosed interest rate. This undermines the consumer's ability to make informed choices, whether between cash and credit purchases or between different credit providers. It results in reduced consumer pressure on credit providers to reduce interest rates;
- An unrealistically low Usury Act cap causes low-income and high-risk clients to be marginalised;
- Weak and incomplete credit bureaux information results in bad client selection, ineffectual credit risk management and high bad debts, hugely increasing the cost of credit;
- Inappropriate debt collection and personal insolvency legislation creates an incentive for reckless credit provision, and prevents effective rehabilitation of over-indebted consumers;
- Excessive predatory behaviour leads to high levels of debt for certain consumers and unmanageable risk to all credit providers;
- Inconsistencies in legislation related to mortgages and property transfers undermine consumers' ability to offer security and locks them into high-cost, unsecured credit;
- Aspects of the Banks Act 94 of 1990 (hereafter "the Banks Act") and National Payment System Act 78 of 1998 (hereafter "the National Payment System Act") rules undermine competition in the consumer credit markets (while creating inequitable preferences for certain credit providers); and
- Regulatory uncertainty leading to credit behaviour orientated towards short-term profit taking, and a resistance among credit providers to provide longer-term finance (including housing and SME finance).

Although it was impossible to trace the cause of the high cost of finance (and limited access) to any single factor, a combination of the factors identified appears to go a long way to explaining the problem. These conclusions were similar to a broader independent study on the provision of financial services for low-income clients by Meagher and Wilkinson (2002).

The Credit Law Committee took stock of the existing consumer credit legislation in South Africa – the Usury Act, the Credit Agreements Act, certain provisions of the Magistrates Courts Act and the common law – and also researched consumer credit reforms in Europe and certain other countries. Furthermore, it consulted widely with various

stakeholders and concluded that both the Usury Act and the Credit Agreement Act should be replaced by a single Act, overseen by a statutory regulator.

The committee recommended that the scope of the new act should be limited to natural persons, thereby insuring that the legislation does not inhibit the flexibility and innovation of SME finance. A main proposal was that the focus should be shifted from price control to protection against over-indebtedness, and to the regulation of undesirable lending practices. Furthermore, special attention should also be given to credit bureaux activities and the disclosure of credit-related fees and charges.

The dti also followed up the Technical Committee with a Policy Framework for Consumer Credit (2004).

The in-depth review of credit legislation initiated by the dti eventually resulted in the promulgation of the National Credit Act 34 of 2005 (published in *Government Gazette* 28619 of 15 March 2006) and the National Credit Regulations (published in *Government Gazette* 28864 of 31 May 2006, *Regulation Gazette* No 8477, R489) in 2006, all with the purpose of solving the consumer credit problems.

See Box 1: The purposes of the National Credit Act (2005), on page 16.

Box 1: The purposes of the National Credit Act (2005)

The preamble to the National Credit Act provides that the main purpose of this Act is:

- To promote a fair and non-discriminatory marketplace for access to consumer credit, and for that purpose to provide for the general regulation of consumer credit and improved standards of consumer information;
- To promote black economic empowerment and ownership in the consumer credit industry;
- To prohibit certain unfair credit and credit-marketing practices;
- To promote responsible credit granting and use, and for that purpose to prohibit reckless credit granting;
- To provide for debt re-organisation in cases of over-indebtedness;
- To regulate credit information;
- To provide for registration of credit bureaux, credit providers and debt counselling services;
- To establish national norms and standards relating to consumer credit;
- To promote a consistent enforcement framework relating to consumer credit;
- To establish the National Credit Regulator and the National Consumer Tribunal; to repeal the Usury Act (1968) and the Credit Agreements Act (1980); and
- To provide for related incidental matters

Section 3 of the National Credit Act sets out all the specific objectives of the Act:

The purposes of this Act are to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers, by:

- a) Promoting the development of a credit market that is accessible to all South Africans, and in particular to those who have historically been unable to access credit under sustainable market conditions;
- b) Ensuring consistent treatment of different credit products and different credit providers;
- c) Promoting responsibility in the credit market by –
 - (i) encouraging responsible borrowing, avoidance of over-indebtedness, and fulfilment of financial obligations by consumers; and
 - (ii) discouraging reckless credit granting by credit providers, and contractual default by consumers;
- d) Promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers;
- e) Addressing and correcting imbalances in negotiating power between consumers and credit providers by:
 - (i) providing consumers with education about credit and consumer rights;
 - (ii) providing consumers with adequate disclosure of standardised information in order to make informed choices; and
 - (iii) providing consumers with protection from deception, and from unfair or fraudulent conduct by credit providers and credit bureaux;
- f) Improving consumer credit information and reporting, and regulating credit bureaux;
- g) Addressing and preventing over-indebtedness of consumers, and providing mechanisms for resolving over-indebtedness based on the principle of satisfaction by the consumer of all responsible financial obligations;
- h) Providing for a consistent and accessible system of consensual resolution of disputes arising from credit agreements; and
- i) Providing for a consistent and harmonised system of debt restructuring, enforcement and judgment, which places priority on the eventual satisfaction of all responsible consumer obligations under credit agreements.”

The Wallis Report (1997) on the “purpose of regulation” stated: “The first purpose (of regulation), which applies in all sectors of the economy, is to ensure that markets work efficiently and competitively. Regulation for this purpose includes rules designed to promote adequate disclosure, prevent fraud or other unfair practices and prohibit anti-competitive behaviour such as collusion or monopolisation. This type of regulation does not materially alter or prescribe the nature of products or services, but simply aims to ensure that they are traded in fair and efficient markets”.

In the context of the National Credit Act this means that creditworthy borrowers from low-income households and the small and micro sectors are not excluded from access to finance/credit.

The fundamental purpose of the Credit Act is to achieve integrity in the credit market and remove the multitude of unfair practices, inappropriate disclosure and anti-competitive practices from the market.

1.3. Main components of the National Credit Act and Regulations

The National Credit Act consists of 173 sections grouped under nine chapters:

- Chapter 1: Interpretation, Purpose and Application of the Act;
- Chapter 2: Consumer Credit Institutions;
- Chapter 3: Consumer Credit Industry Regulation;
- Chapter 4: Consumer Credit Policy;
- Chapter 5: Consumer Credit Agreements;
- Chapter 6: Collection, Repayment, Surrender and Debt Enforcement;
- Chapter 7: Dispute Settlement Other Than Debt Enforcement;
- Chapter 8: Enforcement of Act; and
- Chapter 9: General Provisions.

There are three schedules. The first contains rules on conflicting legislation, the second stipulates the amendment of legislation and the third contains transitional provisions.

This report focuses on the main components of the National Credit Act.. It is not a comprehensive discussion of all the provisions or a detailed discussion of the application of the Act. The National Credit Act must be read with the Regulations promulgated in terms thereof (published in Government *Gazette* 28864 of 31 May 2006, Regulation *Gazette* No 8477, R489). The Regulations are complementary to their enabling sections in the National Credit Act. They provide for matters not specifically dealt with by the sections of the Act, for instance they further regulate the manner in which credit providers provide credit.

The National Credit Regulations consist of 76 regulations grouped under ten chapters:

- Chapter 1: Interpretation and Application of Act;
- Chapter 2: Registration requirements, criteria and procedures;
- Chapter 3: Consumer Credit Policy;
- Chapter 4: Consumer Credit Agreements;
- Chapter 5: Interest and Fees;
- Chapter 6: Dispute Resolution;
- Chapter 7: Record-keeping and Registers;
- Chapter 8: Compliance and Reporting;
- Chapter 9: Transitional Provisions; and
- Chapter 10: Prescribed Forms.

There are also two schedules. The first contains the prescribed forms referred to in the Regulations, while the second sets out the prescribed fees payable for certain services, for example a fee charged by a credit bureau in respect of a credit record may not exceed R20.

See Appendix 1 for a detailed description of the main components of the Act and Regulations.

1.4. Outline of this report

Good theory results in good practice. This study includes the theory of price determination in the credit markets, which will help understand total credit costs (Appendix 2). It also includes a theoretical foundation for the importance of a deep financial sector without which it will be difficult to evaluate the possible consequences (both intended and unintended) of the National Credit Act and its Regulations.

Section 2 is an overview of three types of regulation of consumer credit in selected countries.

Section 3 considers the use of usury interest rates. It is reasoned that the use of a fixed margin on top of the ruling money-market rate (i.e. the underlying minimum cost of credit) together with a fixed fee for administration and related costs, per the regulations' design, is better than a fixed rate, but that price controls are not an optimal method of controlling high rates of interest.

Section 4 addresses the inherent trade-offs between financial stability, efficiency and consumer protection. The ideal consumer protection may in practice simply be too expensive in terms of lost efficiency. Striking the balance between competing policy objectives is ultimately a political decision.

Section 5 analyses key sections of the National Credit Act and their accompanying regulations, systematically: 1. The intention of the regulator; 2. The theoretical foundation of the proposal; 3. The expected costs of the legislation to the consumer; 4. The expected risk of the legislation to producers; 5. Possible unintended consequences of the legislation; and 6. A preliminary conclusion.

The last section of this report deals briefly with the potential impact of the National Credit Act on certain proposed legislation for second-tier banks and for financial services beyond credit.

2. THREE TYPES OF REGULATIONS TO PROTECT CREDIT CUSTOMERS

Three different types of regulation are used to protect credit customers in selected countries with developed financial sectors. Each of these is included in the National Credit Act in some form. In this analysis they are described as three pillars. (See *Table 1: Consumer credit law in selected countries*, on page 24:

- Pillar 1: Lenders may be required to keep within the limits of clients' credit redemption capacities.
- Pillar 2: Lenders are obliged to disclose fully all costs of credit arrangements before a client signs a contract.
- Pillar 3: Caps may be put on the pricing of consumer credit or usury laws may determine that pricing.

The first pillar – assessing client capacity to pay – is implemented by the Swiss Bundesgesetz über den Konsumentenkredit. This is the federal law for consumer credit, which does not apply to secured credit. It states that the maximum share of the attachable income has to be assessed by checking the consumer's borrowing capacity. This attachable income has to be sufficient to pay back the consumer credit (or if the customer has several consumer loans, all loans) within 36 months.

The National Credit Act requires the lender *inter alia* to assess the client's ability to pay, and requires the client to provide full financial information to prevent reckless credit (see sections 80–84 of the National Credit Act).

The second pillar – the disclosure of all costs – is implemented by the European Union and the United States. Directives 87/102/EC and 98/7/EC of the European Parliament and of the Council introduce a specified method of calculating the so-called *annual percentage rate of charge (APRC)*. This method states the equivalence of loans on the one hand and repayments and charges on the other hand⁵. The annual

5

$$\sum_{K=1}^{K=m} \frac{A_K}{(1+i)^{t_K}} = \sum_{K'=1}^{K'=m'} \frac{A'_{K'}}{(1+i)^{t_{K'}}$$

with:

K	is the number of a loan
K'	is the number of a repayment or a payment of charges
A _K	is the amount of loan number K
A' _{K'}	is the amount of repayment number K'
m	is the number of the last loan
m'	is the number of the last repayment or payment of charges

percentage rate thus has to include all charges to the consumer, meaning all costs of the credit including interest and other charges that are directly connected with the credit agreement,⁶ (see below ⁷):

Furthermore, any advertisement or offer displayed in the business premises in which a credit or the arrangement of a credit agreement is offered and which includes a rate of interest or any figures relating to the cost of the credit, must also include a statement of the APRC.⁸

In the United States the annual percentage rate (APR) is defined by the Federal Truth and Lending Law. It is either calculated by the actuarial method or the United States Rule method⁹. Regardless of which method is applied, discount points, origination points, pre-paid interest, loan-processing fee, underwriting fee, document-preparation fee and private

t_k	is the interval, expressed in years and fractions of a year between the date of loan No 1 and those of subsequent loans No's 2 to m
t_k'	is the interval, expressed in years and fractions of a year between the date of loan No 1 and those of repayments or payments of charges No's 1 to m

Fractions of a year are defined by the effective number of days already passed divided by the number of days of the year (365 or 365,25 or 366 for leap years).

⁶ European Council (1987), Article 1a(2)(d)

⁷ The sum loaned is €1 000 of which the creditor retains €50 as administration fee, so that the payout made on 1 January 2005 is in fact €950. The repayment, including interest on 1 July 2006, will be €1 200. For this loan the APRC has to be calculated as follows:

$$950 = \frac{1\,200}{(1+i)^{\frac{546}{365}}} \quad \Rightarrow \quad i = 0,16903 = 16,9 \%$$

European Council (1987), Annex III. A.

⁸ European Council (1998), Article 1(d)

⁹ The United States Rule method capitalises the accrued interest whenever a payment takes place. For the further calculation this capitalised interest payment is included. One year is cut into 360 days. In contrast, under the actuarial method the unpaid balance of the amount financed is increased by the finance charge and decreased by potential payments at the end of each unit period. A unit period is that common period, not to exceed one year, which occurs most frequently in the transaction. If the number of unit periods is a multiple of a month, the number of unit periods a year is 12 divided by the number of months per unit period. If the unit period is a day, the number of unit periods a year is 365.

mortgage-insurance are included. The loan-application fee and the costs of credit life insurance may be included.

The National Credit Act requires comprehensive disclosure of all interest and other fees and charges payable on the principal debt in a percentage and rand value, together with a repayment schedule in the form of a pre-agreement statement and quotation so that the client has time to think about it before committing to the loan (see section 92 of the Act read with regulations 28 and 29).

Furthermore, the National Credit Act and Regulations have stringent disclosure provisions which, depending on the type of advertisement, must be complied with. For example when credit providers advertise specific credit products, offer a specific amount of credit to a consumer, or offer to render services on credit, the following information must be disclosed: the instalment amount; number of instalments; total amount of all instalments (including interest, fees and insurance); residual or final amount payable; and the interest rate and other credit costs (see section 76 of the National Credit Act read with regulations 21 and 22.)

The third pillar – interest rate caps or usury law – is found in Switzerland, France and some of the States in the United States. (As background, the theoretical basis for understanding different components of the total credit price are identified and assessed from a cost accounting standpoint in Appendix 2). In Switzerland, for example, the cap is set by the Bundesrat (Federal Council). The interest rates that banks have to pay for refinancing have to be considered, but the cap should normally stay below 15 % per annum.¹⁰

In France, the usury rule is set by article L. 313-3 of the *Code de la Consommation* (Consumer Code). It states that a loan is usurious if it is granted at a rate that exceeds, at the time it is granted, the average effective rate applied during the prior quarter of the year by credit institutions for loans of the same nature with identical risk, as defined by the relevant administrative authority after consulting the National Credit Council, by more than a third.¹¹

Some states in the US have interest rate ceilings as well. The state of New York set this rate at 16% per annum by Section 5-501 of the General Obligations Law. In contrast, under the Indiana Consumer Credit Code, a system of three steps takes place.¹² These

¹⁰ Bundesversammlung Der Schweizer Eidgenossenschaft (2001), Article 14

¹¹ The rates are published on www.banque-france.fr

¹² The first portion up to an amount of \$990 may be charged with an interest rate up to 36%. The amount between \$990 and \$3 300 has a maximum step rate of 21%. The portion of the unpaid balances above \$3 300 may finally be charged with an interest rate of maximum 15 %. If the

regulations are weakened because credit card operators are regulated by the laws of the state where they are incorporated, and to avoid these interest rate caps, for example, most banks moved their credit card operations to unregulated states such as Delaware. The differences in approach by states to interest rate ceilings enables comparison of similar credit markets with and without interest rate caps (see Section 3).

Another approach to interest rate caps is used in Germany and the United Kingdom. In these countries there are no definitive caps, but usury (respectively exorbitant) interest rates are forbidden by law. Normally these usury interest rates are penalised in Germany by court if the APR is twice as high as the prevailing “normal” rate¹³, and if the loan furthermore has been fixed “by abuse of an exigency, inexperience, of lack of judgment or substantial weak will”.¹⁴ But even here there is scope for interpretation. The rules set by the Consumer Credit Act in the United Kingdom appear to be nearly equivalent.¹⁵

These rules may not be the fact in practice. A 2004 study by the UK Department of Trade and Industry reported that the UK has no ceiling in place. It found that, as a result of no ceiling in the UK and certain US States, sub-prime markets were becoming increasingly diverse and competitive, exerting downward pressure on price. These are complex issues – an analysis of these regulatory mechanisms is included in the next section.

The National Credit Regulations include maximum rates of interest applicable to seven different types of credit¹⁶. These are effectively the usury limits. For instance, unsecured credit transactions are structured as the SA Reserve Bank’s ruling Repurchase Rate times 2.2 plus 20% per annum, which under current circumstances is a maximum rate of 36.5% p.a. However, if the maximum initial¹⁷ and service fees¹⁸ are also included in the all-inclusive interest rate, the maximum effective annual rate may be as high as 4 881% p.a. (see Table 2 and Figure 2 in Section 3).

amount-weighted sum of these three rates results in a rate below 21%, the maximum rate is fixed at 21%. Indiana Department of Financial Institutions, 2004.

¹³ OLG Stuttgart NJW 1979, 2409

¹⁴ BGB § 138, II

¹⁵ Consumer Credit Act of 1974, sections 137 through 140

¹⁶ See regulation 42(1)

¹⁷ See regulation 42(2)

¹⁸ See regulation 44

Table 1: Consumer credit law in selected countries			
	Pillar I	Pillar II	Pillar III
France		APRC includes all costs and has to be published.	A loan is stated as usury when the rate exceeds the average effective rate of the prior quarter (published by the Bank of France) by one-third.
Germany		APRC includes all costs and has to be published.	If the APR is double the market interest rate and there has been abuse of an exigency, inexperience, lack of judgment or substantial weak will, the interest rate is illegal according to court orders.
Switzerland	Attachable income has to be high enough to pay back the credit within 36 months.	APRC includes all costs.	Interest cap usually fixed below 15 % per annum.
United Kingdom		APRC includes all costs and has to be published.	Usurious credit agreements can be reopened by court.
United States		APR includes all costs according to the Federal Truth and Lending Law.	Different regulations in every state.
South Africa	National Credit Act requires lender to assess the client's ability to pay.	All costs must be disclosed in terms of the National Credit Act and Regulations.	Regulations provide for maximum rates of interest applicable to seven different types of credit.

Source: various

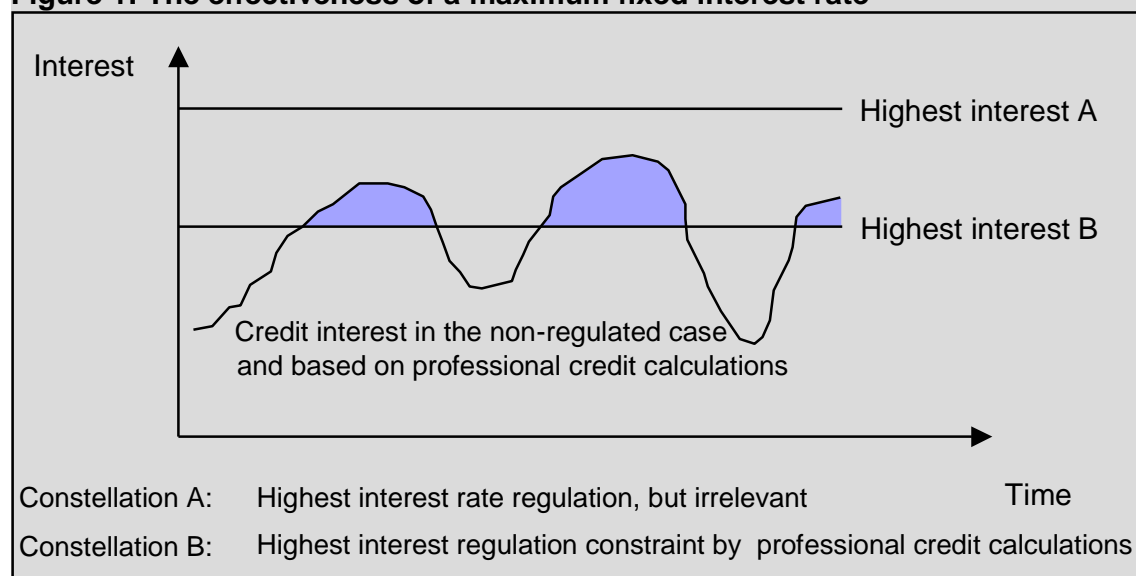
3. USURY LAWS AND INTEREST RATE CAPS AS REGULATORY INSTRUMENTS

This section considers the relationship between usury laws, interest rate caps and access to credit. It consists of two parts. The theoretical and practical shortcomings of a usury interest rate or cap are highlighted with empirical evidence of their impact on increasing access to credit. This is followed by an analysis of the interest rate approach used in the regulations.

3.1. Usury laws, interest rate caps and access to credit

As described in Section 2, many industrial countries have some protection for the consumer against exorbitant or usurious interest rates. However, not so many have a maximum fixed price for credit. Switzerland is still one of the few developed countries that does so, but at such a high rate that it is under normal economic conditions largely ineffective. Likewise, South Africa has maximum prices for specific classes of credit, but these rates are so high (see 3.2) that under normal economic conditions they are likely to be academic.

Figure 1: The effectiveness of a maximum fixed interest rate



Theoretically, if a maximum rate of interest has to be set for political reasons, it can easily be done in a way that does not reduce access to credit. It can be set at a level so high that it never really becomes applicable. For instance, if the maximum fixed interest rate is set at Level A (see Figure 1), it is so high that it can be eliminated from legislation without any financial impact. By contrast, if the maximum fixed-interest rate is set at Level B (see again Figure 1) it may create unintended distortions in the economy.

The basic distortions with a Level B maximum fixed price for credit can be found in all types of financial systems, and are typically the following:

- It lacks sufficient flexibility to adjust to the changing cost of money as determined *inter alia* in the money market. **As a result asset allocation may become inefficient.**
- A maximum fixed rate is a form of price control that in a free market economy should be used with the greatest care. **The financial markets generally are far too flexible for such a harsh instrument.**
- In practice a maximum fixed-interest rate cannot be enforced, and particularly so in a developing country where law enforcement agencies are usually understaffed and underfunded. **Rather no rules, than ineffective rules.**
- Even if the maximum rate could be enforced, it may not be desirable after all – the “pressure cooker” may need a “safety valve”. Accordingly, stringent legislation should allow for all types of reasonable exceptions.
- **Price controls in whatever form usually create parallel (or even grey) markets.** For instance, Regulation Q in the United States, which forbade interest payments on current accounts in 1957, resulted in the creation of the massive Eurodollar market outside the US jurisdiction in the 1960s.
- **If South Africa aims to become a financial centre for Africa, inflexible price controls on interest rates are bound to become counterproductive.**

Recent empirical research goes beyond these economic distortions to provide evidence that Level B interest rate ceilings reduce credit access. The UK DTI undertook a study of the effect of interest rate caps in the UK, Europe and the US, (DTI 2004) and, independently, the Consultative Group to Assist the Poor (CGAP) undertook an analysis of the effects of interest rate controls in almost 40 developing and transition economies (Helms and Reille, 2004). The UK DTI study assessed the impact of interest rate caps on both access and the pricing of credit for low-income groups in the credit markets of: France and Germany which “have long had rate ceilings in place”; the UK, “where no statutory ceilings are in place”; and the US where a comparison was made of “states which have no rate ceilings with those that do”. See *Box 2; Key findings of the UKDTI study of the impact of interest rate caps on access to credit for low-income groups*, on page 26.

Box 2: Key findings of the UK DTI (2004) study on the impact of interest rate caps on access to credit for low-income groups

- All markets demonstrated consistency in the high level of demand (measured as the need to borrow) for credit products among low-income households.
- The much lower observed credit use among low-income households in markets with ceilings is thus attributed to constrained credit options rather than lack of demand.
- Sub-prime markets were becoming increasingly diverse and competitive, exerting downward pressure on price in the UK and US states with no ceiling.
- Rate ceilings reduced the availability of dedicated sub-prime models and created credit exclusion for those who cannot access the credit mainstream.
- Rate ceilings have caused lenders to become much more risk-averse. For instance, in Germany some lenders have withdrawn entirely from low-income market segments. In Germany lenders raised hurdles to access for low-income households, including raising minimum loan sizes above those likely to be sought by low-income borrowers. In Florida, the number of Auto Title Lenders (providing short-term cash credit to unbanked car owners, using a car title to secure the loan) dropped by over 90% after a special rate ceiling was imposed.

The CGAP research by Helms and Reille (2004) found that when faced with an interest rate ceiling, companies and non-governmental organisations (NGOs) providing financial services to poor people will often retreat from the market, grow more slowly, and/or reduce their work in rural areas, or other, more costly market segments because they cannot cover their operating costs.

Similarly, the interest rate ceilings discourage commercial banks from expanding into higher-cost rural or microcredit markets. For example, evidence of market contraction was seen in Nicaragua after the national parliament introduced an interest rate ceiling for specific types of lenders, including NGO-microfinance institutions (MFIs), in 2001. Annual portfolio growth of these MFIs fell from 30% to less than 2%. The imposition of interest rate ceilings also caused several microfinance institutions to leave rural areas, where risks and operational costs are higher.

In West Africa, the regional central bank (Banque Centrale des Etats de l'Afrique de l'Ouest, or BCEAO) enforces an interest rate ceiling of 27% for non-bank lenders. This ceiling applies to microfinance institutions in most countries. As a result, several large MFIs are reported to be withdrawing from poorer, more remote communities and focusing instead on urban areas, which are less expensive to service. MFIs in West Africa are also increasing their average loan size — and presumably serving fewer poor clients — in an attempt to improve efficiency and returns. The country's banks, along with those in the rest of the region, face an even lower ceiling: 18%.

Recent research in Bolivia¹⁹ asserts that interest rate ceilings have retarded the development of commercial microfinance in that country, primarily by discouraging microfinance NGOs from transforming into licensed financial intermediaries. In Kenya, the threat of a new interest rate ceiling bill caused the Cooperative Bank of Kenya to put its plans for a major expansion into the microfinance market on hold.

It is difficult to substantiate arguments about what specific markets might have looked like without interest rate ceilings. However, a comparison of market penetration rates between 23 countries with interest rate ceilings and seven countries without ceilings suggests higher penetration rates in the latter (see Porteous, 2006). On average, the former had a market penetration of 4.6%, whereas countries without interest rate ceilings, or ceilings that had little impact on microcredit, enjoyed penetration rates of 20.2%, more than four times higher.

Morocco and Bolivia, without caps, have significantly higher market penetration rates than their respective peers, Tunisia and Colombia. One factor, among many, differentiating the two pairs is the restrictive interest rate ceiling, whether legal or de facto, that exists in countries with low penetration rates. It should be noted that structural problems related to large-scale state intervention in financial systems, not simply interest rate ceilings, have had a significant effect on microfinance in many countries, including Tunisia.

Enforcing the ceiling is an additional factor. Enforcement varies according to local conditions, including the clarity of the law or regulation and the incentives and institutional capacity of the agency charged with enforcement. In Colombia and some West African countries, such as Mali, interest rate ceilings are reported to be strictly enforced. However, interest rate ceilings are often difficult to enforce, particularly when it comes to microfinance.

The laws establishing them, especially usury laws, are often proposed by politicians and not by agencies or other groups with expertise in finance. The responsibility for enforcement is not always clear or is placed with bodies without adequate technical expertise. Since the laws often apply to large numbers of non-bank institutions or even individuals, these authorities simply do not have the enforcement capacity required — as is the case in Armenia, and several countries in Latin America.

In the UMOA, (Union Monétaire Ouest Africaine - Monetary Union of West Africa) the Ministry of Finance in Benin (and, indeed, in most participating UMOA countries) has

¹⁹ Gonzalez-Vega, C., and M. Villafani Ibarnegaray. *Las Microfinanzas en el Desarrollo del Sistema Financiero de Bolivia*. La Paz: Proyecto Premier, 2004.

been unable to supervise all licensed and registered MFIs in the country effectively due to a lack of capacity, both human and technical.

Since the creation of the special microfinance unit (Cellule Microfinance) at the Benin Ministry of Finance, only 14 MFIs have had an on-site inspection. Under the law, all MFIs have to submit their annual financial statements, but in 2000 only 35 statements were received, representing a compliance rate of approximately 41%. No sanctions were levied against noncompliant licensed MFIs. To put the supervision workload into perspective, the regional Banking Commission for the entire UMOA region supervises a total of 59 commercial banks, while the Cellule Microfinance in Benin monitors 83 licensed MFIs.

Evidence from both developed and developing economies shows that credit price controls discourage the provision of small loans to low-income clients, and are difficult to enforce.

3.2. Costs of credit and the National Credit Act and Regulations

The maximum interest rate ceiling in South Africa, which is set out in the Regulations, is so high at present that it is unlikely to curtail any form of credit to the S(M)ME sector. Table 2 on page 29 calculates in detail the effective maximum total cost of credit for SME's (mainly unsecuritised loans for productive use).

Table 2: National Credit Act - Interest Rate and Fee Regulations									
Total cost of credit (TCOC) and interest estimates for developmental credit (SMEs)									
Loan size	Period (in months)	Maximum interest rate	Maximum initial fees	Maximum service fees	Total cost of credit (TCOC)	Repayment (excluding service fees)	i% p.m. (including TCOC)	i% p.a. (including TCOC)	Effective i% (cumulative) (p.a.)
250	1	7.60	37.50	50.00	95.10	-296.24	38.5%	462.0%	4881.0%
500	1	15.21	75.00	50.00	140.21	-592.49	28.5%	342.0%	1926.6%
750	2	45.63	112.50	100.00	258.13	-451.02	21.7%	260.4%	955.2%
1,000	2	60.83	150.00	100.00	310.83	-601.37	19.6%	235.2%	766.6%
1,250	3	114.06	187.50	150.00	451.56	-508.61	16.2%	194.7%	507.4%
1,500	3	136.88	225.00	150.00	511.88	-610.33	15.3%	183.7%	452.6%
1,750	4	212.92	262.50	200.00	675.42	-541.96	13.3%	159.5%	347.3%
2,000	4	243.33	300.00	200.00	743.33	-619.38	12.8%	153.4%	323.6%
2,250	5	342.19	337.50	250.00	929.69	-565.66	11.4%	137.4%	267.2%
2,500	5	380.21	375.00	250.00	1,005.21	-628.52	11.1%	133.5%	264.6%
2,750	6	501.88	387.50	300.00	1,189.38	-579.97	9.9%	119.1%	211.2%
3,000	6	547.50	400.00	300.00	1,247.50	-628.50	9.5%	113.8%	196.7%
3,250	7	691.98	412.50	350.00	1,454.48	-588.78	8.7%	104.1%	171.4%
3,500	7	745.21	425.00	350.00	1,520.21	-630.98	8.4%	100.5%	162.6%
3,750	8	912.50	437.50	400.00	1,750.00	-597.59	7.8%	93.6%	146.2%
4,000	8	973.33	450.00	400.00	1,823.33	-635.05	7.6%	91.0%	140.4%
4,250	9	1,163.44	462.50	450.00	2,075.94	-606.42	7.1%	85.8%	129.0%
4,500	9	1,231.88	475.00	450.00	2,156.88	-640.20	7.0%	83.8%	124.8%
4,750	10	1,444.79	487.50	500.00	2,432.29	-615.30	6.6%	79.8%	116.6%
5,000	10	1,620.83	500.00	500.00	2,620.83	-646.14	6.5%	78.2%	113.4%
5,250	11	1,756.56	512.50	550.00	2,819.06	-624.23	6.3%	75.0%	107.0%
5,500	11	1,840.21	525.00	550.00	2,915.21	-652.67	6.1%	73.8%	104.6%
5,750	12	2,098.76	537.50	600.00	3,236.26	-633.23	5.9%	71.2%	99.6%
6,000	12	2,190.00	550.00	600.00	3,340.00	-659.66	5.8%	70.2%	97.8%
6,250	13	2,471.35	562.50	650.00	3,683.85	-642.28	5.7%	68.0%	93.7%
6,500	13	2,570.21	575.00	650.00	3,795.21	-667.03	5.6%	67.2%	92.2%
6,750	14	2,874.38	587.50	700.00	4,161.88	-651.41	5.4%	65.3%	88.9%
7,000	14	2,980.83	600.00	700.00	4,280.83	-674.71	5.4%	64.6%	87.7%
7,250	15	3,307.81	612.50	750.00	4,670.31	-660.60	5.3%	63.1%	84.9%
7,500	15	3,421.88	625.00	750.00	4,796.88	-682.66	5.2%	62.5%	83.9%
7,750	16	3,771.67	637.50	800.00	5,209.17	-669.86	5.1%	61.1%	81.5%
8,000	16	3,893.33	650.00	800.00	5,343.33	-690.83	5.1%	60.6%	80.6%
8,250	17	4,265.94	662.50	850.00	5,778.44	-679.20	5.0%	59.4%	78.6%
8,500	17	4,395.21	675.00	850.00	5,920.21	-699.20	4.9%	59.0%	77.9%
8,750	18	4,790.63	687.50	900.00	6,378.13	-688.61	4.8%	58.0%	76.1%
9,000	18	4,927.50	700.00	900.00	6,527.50	-707.76	4.8%	57.6%	75.5%
9,250	19	5,345.73	712.50	950.00	7,008.23	-698.09	4.7%	66.7%	73.9%
9,500	19	5,490.21	725.00	950.00	7,165.21	-716.48	4.7%	66.3%	73.4%
9,750	20	5,931.26	737.50	1,000.00	7,668.76	-707.64	4.6%	55.5%	72.0%
10,000	20	6,083.33	750.00	1,000.00	7,833.33	-725.36	4.6%	55.2%	71.5%

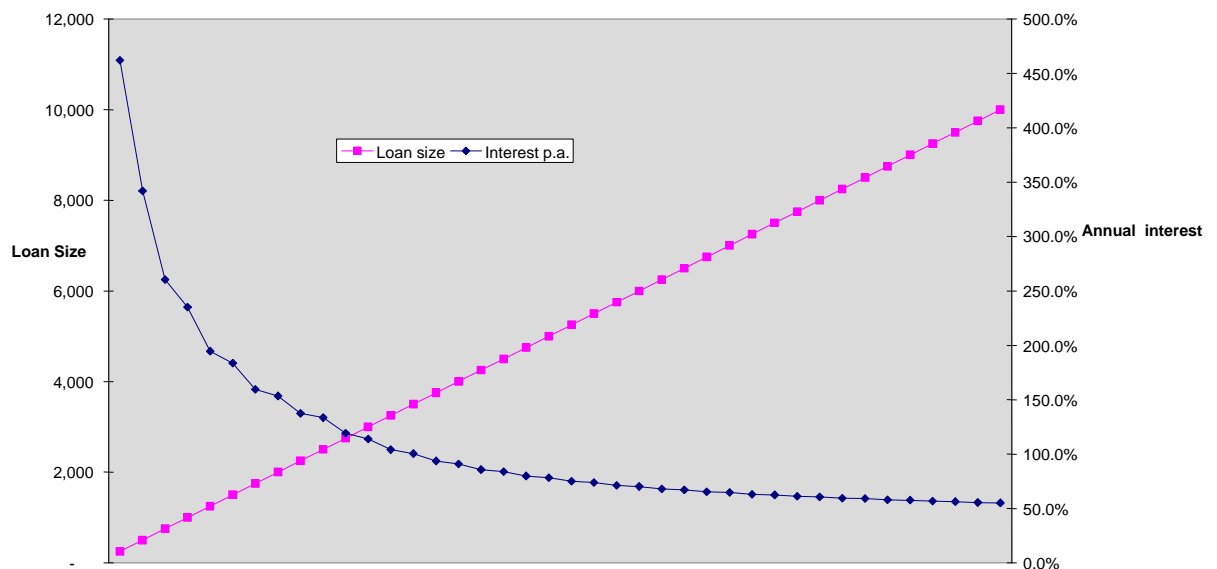
The Total Cost of Credit (TCOC) depends on the ruling repurchase rate of the SA Reserve Bank (i.e. 2.2 times this rate, plus 20%) as well as the maximum initial and services fees. Initial fees are capped at 15% of the loan amount, and the service fee is capped at R50 a month for the full loan period. For very small loans of very short duration,

the maximum allowable cost of credit is therefore about 450% per annum,. which is equal to an effective cumulative interest rate of nearly 5 000% a year. But even for larger loans (say a R10,000 loan for 20 months) the annual interest rate is still in excess of 50% (or more than 70% if the effective cumulative annual rate is used).

Few, if any, capital outlays can be justified if the total cost of credit is so high. In fact, loans granted at say 50% per annum may well trigger insolvencies, particularly if borrowings are already relatively large. In such case the creditor may even become involved in a reckless lending operation. Accordingly, creditors may be hesitant to grant credit at excessively high rates (which may be allowed, but are non-commercial nonetheless). In essence, this implies that the cutting edge of the new National Credit Act is foremost the reckless lending rule, rather than the maximum interest rate ceiling.

Although the maximum interest rate ceiling could well be viewed as an unnecessary ruling (as the reckless lending rules are likely to kick in earlier), they may still serve a limited purpose during the initial phasing in of the new Act. It may also effectively deal with some exceptionally ferocious loan sharks. Time will tell whether there is indeed a need for maximum interest rate ceilings. Ideally, they should be abolished as soon as possible, but then as the saying goes, “Less haste, more speed”.

Figure 2: Loan Size vs Annual Interest Rates for Unsecured Credit



4. EXPLORING TRADE-OFFS BETWEEN FINANCIAL STABILITY, EFFICIENCY, CONSUMER PROTECTION AND ACCESS TO CREDIT

This section goes beyond interest rates to trade-offs in financial stability, efficiency, consumer protection and access to credit. To that end, Porteous (2006) evaluated better ways for regulators to achieve their goals of lowering interest rates with mechanisms that still provide consumer protection and expanded access to credit. He found the following had been effective, and each one is already in the National Credit Act in some form:

- **Disclosure:** Requiring transparent, comparable pricing by providers, facilitates competition on price while also providing customers with accurate price information.
- **Education:** Promoting consumer financial literacy, so clients can understand pricing claims and understand financial choices.
- **Market Analysis:** Collecting, assessing and publishing credible market-level information, i.e. tracking key competitive indicators, such as number of clients, weighted average interest rates, and the level of market saturation.
- **Credit Bureaux:** When communications infrastructure allows, developing reliable consumer credit bureaux that allow borrowers to build a good credit record that is accessible to competing lenders. Porteous argues this is particularly critical because, in the absence of information-sharing mechanisms, competition is likely to lead to increasing the multiple indebtedness of clients.

These findings all show that interest rate caps, Pillar 3, may not be economically desirable, effective or necessary for consumer protection against usurious lending, and other actions may be more appropriate.

To address the inherent trade-offs between the various regulatory objectives, the South African regulatory authorities follow international practice by applying the target-instrument approach to regulation (see Falkena *et al.*, 2001). In practice this implies that the authorities target only three regulatory objectives with a whole range of policy instruments. In a nutshell this implies the following:

- **Financial stability:** This is aimed at by applying *inter alia* the Basel Accord Regulations in respect of the various risk exposures of banks (and similar types of rules for other financial institutions).

- **Efficiency:** This is encouraged by ensuring *inter alia* a competitive and level playing field for the various players (both local and from abroad).
- **Consumer protection:** This is enhanced by *inter alia* disclosure rules, information sharing legislation, usury legislation, and complaints and compensation rulings.

As a general rule the regulatory instruments (like capital rulings, competition rulings or disclosure rulings) should be independent of each other, allowing for the simultaneous pursuit of conflicting regulatory objectives (for more detail see: Falkena and Llewellyn, 1999). Policy trade-offs are then not really applicable, as every instrument works independently of the other instruments towards its specific goals. However, the problem of trade-offs does appear if policy instruments are not independent, as well as in certain extreme cases of over-regulation.

An example of the first category is the interest rate instrument, which simultaneously targets price stability (e.g. via exchange rate policy) and economic growth (cost of capital and thus investment policy). An example of an extreme form of over-regulation would be disclosure requirements that stipulate the completion of a standard risk-disclosure document of say 675 pages for every loan in excess of say R1 237. In this case, the financial sector's efficiency and stability will be impaired by excessive consumer protection rulings (in the sense that the normal business of banks will come to a grinding halt, even, as Dr Falkena put it, "ignoring the fact that industry has to deal with a lunatic as regulator, which as an aside may well be the highest cost of all").

On access to credit and the National Credit Act, the issue is foremost a possible policy trade-off between consumer protection (as reflected in usury rates and the provisions against reckless lending) and access to credit that may become limited if consumers reach (subjectively set) limits of creditworthiness. Crucial to the evaluation of alternatives is the use of credit, namely whether credit is used to finance investments (and ultimately economic growth and employment opportunities) or consumption (which reduces savings and thus investments)²⁰.

20 FinMark Trust has developed a Policy Lens tool to assist South African policy makers. This is accessible via www.finmarktrust.org.za. Financial policymakers work in a complex environment where policy arises from a number of (public and private) sources and where objectives are wider than in the past. The policy focus used to be purely on preserving systemic stability and correcting obvious market failures, but now a more proactive role is emerging, one that actively seeks to develop the financial markets (in particular, ensuring access to financial services for previously neglected consumers).

4.1. Investment Loans and the National Credit Act

Theoretically, the smaller the enterprise, and/or the more uncertain the profitability profile of its business, the more attractive equity capital becomes as a funding source to finance investments (because equity distributes dividends only after profits have been made). As the business grows in size, loan capital (with its strict interest payment obligations, irrespective of profits made) may become more attractive. Nonetheless, creditors will consider carefully the full financial profile of the business including the various gearing ratios (e.g. the ratio of own capital to credit) before granting a credit facility. In short, the foremost need of medium, small and micro businesses is equity capital from “business angels”, i.e. entrepreneurs who are willing to make an equity investment in promising businesses. This can be supported by the government through tax policy.²¹

Micro-entrepreneurs in the informal sector cannot find business angels, because of the informal nature and the perceived risk of their businesses. However, the nature of micro-entrepreneurs is that they have several business sources of income, many of which generate high enough daily returns to pay back even a loan shark, and they have multiple means of reducing their risk. This is vividly reported by Collins (2005) in the South African Financial Diaries. For them, borrowing money to buy raw materials etc. from family, friends and any other source they can find is essential. In developed economies they could use credit cards, but in South Africa that is not yet an option. So, even though the National Credit Act deals in essence with consumer credit, *de facto* it also deals with credit for microbusiness.

²¹ In May 2006 ECI Africa published a study on “*Tax Incentives for private investors in small businesses*”, recommending that angel investors receive incentives to overcome an “equity gap” for SMEs.

The National Credit Act also applies to a credit agreement in which the consumer is a company, close corporation, partnership, a trust with three or more individual trustees or the trustee is itself a juristic person, or any other association or body of persons irrespective of whether or not it is registered in terms of any act, **provided its asset value or annual turnover, at the time the agreement is made, does not equal or exceed R1,000,000.**²² This limitation does not apply where the consumer is a stokvel. This means that, even if a stokvel has an asset value or annual turnover, at the time the agreement is made, that equals or exceeds R1,000,000, such a stokvel will have the full protection of the National Credit Act and the Act will fully apply (see section 4(1) (a) read with section 1 of the National Credit Act). This also holds true for a sole proprietor (i.e. “one man business”). This means that the sole owner of a large business will be able to allege that the lender granted the credit recklessly and may even have himself declared over-indebted.

However, although the National Credit Act protects and applies where the consumers are small, medium and even micro businesses (e.g. business which do not have an asset value or annual turnover that equals or exceeds R1,000,000), the Act does have limited application in these situations. For instance, the provisions relating to reckless lending and over-indebtedness, and also the provisions limiting the interest rates and other costs of credit will not apply (see section 6 of the National Credit Act). This means that lenders may charge any interest rate and other costs of credit when they conclude credit agreements with these small and medium businesses, without having to fear that such an agreement might be declared a reckless lending transaction. The National Credit Act attempts to relieve these constraints from business lending (excluding lending to certain trusts and one man businesses). This is only one of the many areas where the National Credit Act differs from the repealed Usury Act, which applied to all business credit that fell in its scope.

It could be argued that the fact that the Usury Act and its limitations have been repealed might lead to lenders or “business angels” being more prepared to grant credit to these micro businesses as they would now be in a better position to ask their own interest rates and other credit costs to compensate for the risk factor involved when granting such loans. Again, only time will tell whether this will be the case.

Even for sizeable enterprises (see Table 3 on page 36), i.e. ones large enough to be rated by Standard and Poor’s, a low-rated business remains risky. In fact, more than half

²² However, if such a business consumer with an asset value or annual turnover equal or below R1 000 000 concludes a large credit agreement, for example concludes any mortgage agreement or a credit transaction or signs a credit guarantee for an amount equal or above R250 000, then the National Credit Act will not apply to **THAT** large credit agreement (see section 4(1)(b)).

of all companies in the investment class CCC/C fail after five years (see Table 3). The failure rate of medium, small and micro in particular must be even higher in South Africa. So it might seem to some that credit would not be prudent for these smallest enterprises, but that would be misleading. The Technical Credit Review Committee found that of the 25% of “consumer” credit (with an aggregate value of approximately R95bn) used by the low- and middle-income groups (85% of the population) included micro-loans used for working capital for micro-enterprises. Much of this credit was paid back from the earning of the business or another business run by the same person, or a salary or from savings. These micro-entrepreneurs do not need to be told to stop borrowing and start saving. They want to get out of the debt cycle and increase their saving. They need practical solutions to help them learn how to do that.

Table 3: Cumulative average corporate default rates (1980-2004 %)					
(By years after initial rating)					
Rating	1 year	5 years	10 years	15 years	
AAA	-	0.10	0.45	0.61	
AA	0.01	0.30	0.85	1.35	
A	0.04	0.61	1.94	2.98	
BBB	0.29	2.99	6.10	8.72	
BB	1.20	11.25	19.20	22.59	
B	5.71	25.40	33.75	38.63	
CCC/C	28.83	50.85	56.45	59.44	
Investment grade	0.11	1.20	2.71	3.92	
Speculative grade	4.91	20.22	28.25	32.42	
All rated	1.64	7.08	10.45	12.51	
Source: The Economist, 26 March 2005, based on data from Standard & Poor's					

4.2. Consumption loans and the National Credit Act

Theoretically, households should use credit to finance only capital goods, but as the popularity of credit cards shows, this is not the case in practice. A residential property is a capital good that often underlies the creation of human capital (because education needs the silence of a quiet neighbourhood), but may also be seen as a sound inflation-proof long-term investment. Likewise, a motor car used foremost to travel to work (and particularly in South Africa where public transport is generally poor) could be seen (with some stretch of imagination though) as an investment rather than a consumption article (i.e. despite the fact that vehicles depreciate sharply after five years). These capital goods are normally financed for periods of more than five years. Governments across the developed world usually support the accumulation of capital goods by households by various types of incentives (mostly tax incentives).

Saving up and saving down: To use short-dated credit to finance pure consumption expenditure is not advisable in general. In contrast to credit used for capital goods – where the return on capital can exceed the cost of capital and so justify the use of loan capital – any credit used for consumption is an expensive outlay to buy time. Instead of saving first, and then spending, credit allows immediate consumption and savings later (the repayment of the loan, which is a form of saving). Rutherford (2001) calls it “saving up” vs. “saving down”. Obviously, pure consumption expenditure, in contrast to investment, has no internal rate of return. From a broad policy point of view, consumer credit use should therefore not be encouraged²³. What should be encouraged are savings! In this respect South Africa does badly, as gross savings by households amounted to only R7,5-billion in 2004, or only 0,6% of Gross Domestic Product. This low gross savings rate prevents the economy from reaching a structurally higher growth rate (thus creating more employment opportunities).

Currently the total credit market is R490-billion in South Africa, of which mortgage advances and motor vehicle instalment sales amount to about R295-billion and R95-billion respectively. Short-dated credit is therefore around R100-billion, of which overdrafts and credit card debt represent R60-billion. Total micro loans and credit supplied by stores are estimated around R20-billion each. Pure consumer credit with a duration of less than five years amounts to around R100-billion. This amount of credit costs about R25-billion in service charges (i.e. more than three times the amount saved

²³ Interest rates ranging from 80% to 150% are not unusual for many financial products in South Africa. In economic terms, consumers can only “benefit” from such credit if their returns exceed this cost. And it seems highly unlikely in the vast majority of cases that this will be true (perhaps only for emergency credit and items such as education. In these cases, the “return” may be very high ... but impossible to quantify!)

by households!) and is a high price indeed to pay for a “timing” advantage of consuming immediately rather than five years later.

Part of this credit may have been used for unexpected emergency items such as medical expenses or storm repairs. Theoretically these types of expenses should be covered by household insurance (medical aid and short-term insurance) and not with credit, but most of the low-income population has no access to such insurance. The FinScope (2005) study shows that less than 10% of the population and less than 0.2% of the adult population in LSM 1-5 have short-term insurance. Also credit may be more rational than medical insurance due to the high cost of medical insurance in South Africa. Likewise, educational expenditure should theoretically be financed out of savings made in the past (which ‘should’, in a perfect world, earn inflation-beating interest), and not with savings in the form of loan repayments (particularly if these interest rates are sky high).²⁴ But with frequent emergency expenses it is hard for low-income clients to “save up” that much unless they are part of a stokvel or have a savings plan. This shows the importance of financial literacy and financial education so that consumers fully understand their options. Nonetheless, as long as consumers can finance their credit obligations, it should be considered a private affair.

However, the moment consumers start to default on their loans, the State (i.e. the taxpayer) *de facto* becomes involved. For instance, debt collections involve the law enforcement agencies, courts of law, physiological treatment in State hospitals, and other forms of public expenses to various degrees – all of which are a great expense to the community at large. The dilemma is the long-standing trade-off between private benefits and public costs. To strike a balance between these two objectives, i.e. freedom and its costs, is ultimately a political decision. Generally in those cases in which the “law of diminishing returns” works badly, care is needed. For instance, it is not generally considered wise policy to make more drinks available to an alcoholic (consumer demand conflicts with consumer protection); likewise it is not wise regulatory policy to make more credit available to already over-indebted consumers. The line in the sand between acceptable and unacceptable consumer credit is determined by the creditworthiness of the consumer.

In the National Credit Act terms like “over-indebtedness” and “reckless lending” are the key concepts, which ultimately determine whether a consumer is creditworthy. Looking particularly at sections 79, 80 and 81 of the Act, the two key terms are defined as follows:

²⁴ Credit often plays the role of “substitute” for substantial failures in other sections of the financial market. A lack of appropriate savings facilities for the lower-income categories is one obvious shortcoming, but another would be the lack of availability of appropriate and fairly priced insurance products for the low-income market. Not having access to such savings facilities and insurance products, a large number of South Africans use credit (i.e. micro-loans) as a substitute. A very expensive substitute for those who can least afford it!

(i) **Credit is lent recklessly** if,

- Either the credit provider took no steps to assess the proposed consumer's general understanding and appreciation of the risks and costs of the proposed credit agreement and his rights and obligations under the agreement; his debt repayment history for credit; existing financial means, prospects and obligations (i.e. assessment whether a consumer can make the repayments); and whether there is a reasonable basis to conclude that any commercial purpose may prove to be successful, if the consumer has such a purpose for applying for the credit; **or**
- After conducting an assessment, the credit provider still entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that the consumer did not generally understand or appreciate his risks, costs or obligations under the proposed credit agreement; or if entering into that credit agreement would make the consumer over-indebted (see section 80(1) read with section 81(2) of the National Credit Act).²⁵

(ii) **Over-indebtedness** is defined as follows (see section 79 of the National Credit Act):

“A consumer is over-indebted if the preponderance of available information at the time a determination is made indicates that the consumer is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, having regard to that consumer's:

- (a) financial means, prospects and obligations;²⁶ and
- (b) probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, as indicated by the consumer's history of debt repayment.”

²⁵ Note, however, that the provisions of reckless lending do not apply to a school loan, student loan, and an emergency loan, provided the necessary information is reported to the Regulator (see section 78(2) of the Act, read with regulation 23).

²⁶ The National Credit Act (see section 78(3) clearly provides that “financial means, prospects and obligations” in this context, of a consumer or prospective consumer, includes the following:

- income, or any right to receive income, regardless of the source, frequency or regularity of that income, other than income that the consumer or prospective consumer receives, has a right to receive, or holds in trust for another person; and
- the financial means, prospects and obligations of any other adult person within the consumer's immediate family or household, to the extent that the consumer, or prospective consumer, and that other person customarily share their respective financial means; and mutually bear their respective financial obligations; and
- if the consumer has or had a commercial purpose for applying for or entering into a particular credit agreement, the reasonably estimated future revenue flow from that business purpose.

Although the National Credit Act has refined these definitions and clearly prohibits a credit provider from entering into a reckless credit agreement with a prospective consumer, there will still be those creditors who argue against the “reckless lending rule”, because they wish to make loans even where the evidence indicates that the consumer cannot make the repayments! Jesse H. Jones once said: “One of the greatest disservices you can do to a man is to lend him money that he can’t pay back.”

“It takes two to tango”, and the same applies in the consumer credit market: over-indebted consumers (persons who may be addicted to credit or who are caught in a debt trap) may try to obtain new loans by not declaring the full extent of existing loans, while predatory lenders (loan sharks) engage in reckless lending with people who are already unable to service their existing loans.

Over-indebted consumers and predatory lenders often depend on each other for their existence. While respecting individual freedom, the National Credit Act tries to break this link between over-indebted consumers and predatory lenders.

The National Credit Act provides that whenever a credit agreement is being considered in any court proceedings, the court may declare the credit agreement reckless. If a court declares that a credit agreement is reckless, because the credit provider failed to do the proper assessment, or if he did do the assessment but still entered into the agreement even though the consumer did not generally understand or appreciate the risks, costs or obligations under the agreement, the court may make an order:

- Setting aside all or part of the consumer’s obligations under that agreement, as the court determines is just and reasonable in the circumstances; or
- Suspending the force and effect of the credit agreement and may then issue an order:
 - suspending the force and effect of that credit agreement until a date determined by the court; and
 - restructuring the consumer’s obligations under any other credit agreements, in accordance with the Act (see sections 83(1)–(2)).

The Act also provides that if a credit provider did a proper assessment of the debtor's situation and still entered into the agreement, despite the fact that entering into that agreement would make the consumer over indebted, the court:

- Must further consider whether the consumer is over-indebted at the time of those court proceedings; and
- If the court concludes the consumer is over-indebted, the court may make an order:
 - suspending the force and effect of that credit agreement until a date determined by the court; and
 - restructuring the consumer's obligations under any other credit agreements, in accordance with the Act (see sections 83(1) and (3)).

However, before making such an order the court must consider the consumer's current means and ability to pay the financial obligations that existed at the time the agreement was made; and the expected date when any such obligation under a credit agreement will be fully satisfied, assuming the consumer makes all required payments in accordance with any proposed order (see section 83(4)).

The National Credit Act sets out the effect of a suspension of a credit agreement (see section 84). During the suspension period, the consumer does not have to make any payment under the agreement: no interest, fee or other charge under the agreement may be charged to the consumer, and the credit provider's rights under the agreement, or under any law in respect of that agreement, are unenforceable, despite any law to the contrary.

The Act also provides that after the suspension has ended, all the respective rights and obligations of the provider and the consumer under that agreement are revived; and are fully enforceable except to the extent that a court may order otherwise (see Section 84)

Therefore to prevent consumers from abusing the reckless lending provisions set out in the National Credit Act, the following sections were included:

- Section 81(1) requires that when a consumer applies for a credit agreement, and while that application is being considered by the credit provider, the prospective consumer must fully and truthfully answer any requests for information made by the credit provider while he is assessing whether or not to grant the credit.
- While section 81(4) determines that "For all purposes of this Act, it is a complete defence to an allegation that a credit agreement is reckless if:

- The credit provider establishes that the consumer failed to fully and truthfully answer any requests for information made by the credit provider as part of the assessment required by this section; and
- A court or the Tribunal determines that the consumer's failure to do so materially affected the ability of the credit provider to make a proper assessment.”

Therefore, the consumer cannot benefit from the reckless lending provisions by not disclosing all financial obligations. If the consumer failed to disclose all the relevant information to the credit provider when he applied for the credit, that credit agreement will not be deemed to have been granted recklessly (provided of course that the credit provider did a proper assessment as required by the National Credit Act).

By striving towards proper lending to consumers, the legislator not only protects the consumer²⁷, but also improves the financial stability of financial institutions.

Moreover, more disclosure, i.e. more consumer protection, also improves competition and thus efficiency.

In the end reckless lending has its origins in failures somewhere else in the financial system, such as:

- Lack of equal access to the National Payments System. If a bank lends to an already over-indebted consumer today, but can collect its full loan installments before older creditors can do so, the reckless lending operation can be extremely profitable (this is in essence a form of insider trading). That the consumer will default in the end does not really affect the reckless lender, as other (older) creditors will carry the cost of default.

²⁷ The Helms and Reille (2004) research found that “predatory lending and unscrupulous business practices, such as lending without regard for a borrower’s ability to repay, deceptive pricing, and abusive collection techniques probably hurt borrowers more than high interest rates do. Therefore, adequate consumer protection laws are needed to provide a safeguard against abuses without the negative effects of interest rate ceilings.”

They found that such consumer protection laws included the definition and prohibition of “abusive” lending and collection practices, mandatory transparent disclosure of interest rates and total loan costs using standardized mathematical formulas applicable to all types of lenders, clearly defined complaint resolution procedures, mandatory consumer education to prevent abuse, and effective enforcement mechanisms.. Truth-in-lending laws, for example, typically require lenders to disclose to borrowers the true cost of a loan as an effective interest rate, as well as to explain other key loan terms in all loan documents and other publicly accessible materials, such as advertising. Such consumer protection is clearly the Act

- A consumer can be “cash-strapped, and (a bit) “asset rich”. Reckless lending becomes commercially viable if the client can be forced into bankruptcy and assets liquidated (this is a variation of the slash and burn policy used in the agriculture sector).

The removal of over-indebted consumers from the consumer credit markets ultimately improves the working of financial markets. To make additional consumer loans to an individual with an excessive default probability can only be attractive to predatory lenders if “others” foot the bill for this default. Either “other consumers” are loaded with this cost (as the APRC will include this very high expected loss as a standard expense), or the reckless lender is able to jump the queue in terms of loan repayments, in which case an initial sound credit turns unsound for “other creditors”. The costs of the time taken to deal with over-indebted clients should not be lost sight off. Most of these “dead-loss expenses” can be avoided if a potentially over-indebted client is identified at an early stage.

Last, in terms of policy trade-offs, the National Credit Act does not appear to target a reduction in over-indebtedness at the cost of reduced access to credit for capital goods. Ensuring fair and equal access to finance for all income categories is a crucial part of government policy. The regulatory target is to lower over-indebtedness to the advantage of credit granted for household’s capital goods, and mortgage finance in particular. Accordingly the aim is for debtors to switch their short-dated micro loan component to the advantage of long-term mortgage finance. This may be feasible for some holders of micro-loans but unfortunately it is unrealistic for the smallest micro-businesses without land title or other assets. They are unlikely to be able to access long term mortgage finance.

Section 13(1) of the National Credit Act, stipulates that it is the primary tasks of the National Credit Regulator to: “Promote and support the development, where the need exists, of a fair, trans-parent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry to serve the needs of: (i) historically disadvantaged persons; (ii) low-income persons and communities; and (iii) remote, isolated or low density populations and communities in a manner consistent with the purposes of this Act”

section 18(1)(c) of Act, provides that the Regulator also has the responsibility to:

“Report to the Minister annually on—

- (i) the volume and cost of different types of consumer credit products, and market practices relating to those products; and

- (ii) the implications for consumer choice and competition in the consumer credit market”.

The Regulator has to monitor and report on his own progress as he implements the Act. However, it is difficult to report impartially on one’s own performance. It may therefore help the Regulator if an independent research group also undertakes an assessment from the perspective of clients and their access to credit, including whether there are any constraints outside of the ambit of the credit legislation with this shift from informal to formal market structures.

If the two reports are consistent in their findings, this would bolster the Regulator’s work. An independent assessment is consistent with the Financial Sector Charter, which undertakes to monitor access and implement mechanisms for the continuing review of the impact of its initiatives on access.

This independent assessment could be viewed as a Regulatory Impact Assessment. However, what is being proposed is not an assessment of the regulation against its problem-solving objectives. Rather it would start from the perspective of the microcredit borrowers and would-be borrowers and ask how their access to credit or the terms of their credit has changed, if at all. By starting from the perspective of the borrower, an assessment might also contribute to improved consumer education if it encouraged clients to think about alternative forms of financing including all forms of “saving up”.

5. ANALYSIS OF CERTAIN SECTIONS OF THE NATIONAL CREDIT ACT AND THEIR ACCOMPANYING REGULATIONS AND POSSIBLE OBJECTIONS

Section 3 of the National Credit Act states:

“The purposes of this Act are to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers...”

This section addresses potential problems with key sections of the National Credit Act and accompanying regulations, in particular whether they will limit (unintentionally perhaps) access to credit by the poor. The issues are over-regulation in terms of disclosure and information-sharing requirements; the desirability of a usury interest rate cap; the definitions of “over-indebtedness” and “reckless lending”; the desirability of limiting the National Credit Act to natural persons only; the principle of eliminating preferential deductions; and the typical compliance costs of fulfilling the regulatory requirements for debt collections; the running of a National Credit Register, the law enforcement through a National Credit Regulator; and the debt rehabilitation processes.

Quantifying the impact of the policy issues in the National Credit Act and Regulations may take years, and is primarily the job of the Regulator. Agreement on measurement and the setting of regulatory standards for “expected and unexpected loan losses” took the Basel Banking Committee nearly a decade. Without this pioneering work by the Basel Committee, it would have been impossible to deal with the conceptual issues of APRC in Section 3 of this analysis in such a short way. Therefore, the debate in this Section is based on principles.

5.1. Regulations and sections to improve disclosure requirements and information sharing

This section refers to the National Credit Act, chapters 4 and 5, and the National Credit Regulations, chapter 3, Part A-C and Chapter 4)

5.1.1. The intention of the regulator

The intention of more disclosure is to tackle a range of problems in the credit markets. A lack of proper disclosure has resulted, for instance, in the following types of consumer complaints:

- The actual cost of credit was frequently much higher than initially disclosed;

- Non-disclosure, or false or misleading disclosure, made competitive price comparisons impossible; and
- The quotation of a variable basis rate – to avoid transparency and proper disclosure – resulted in far higher credit costs than initially envisaged. For instance, a quote for a “zero-interest loan for six months”, makes it impossible for the consumer to assess the real cost or the real repayments.

To address these shortcomings the new disclosure requirements will require:

- The disclosure of full information on the cost of the credit, including all fees and insurance, the type of interest in percentage terms and real value, as well as the complete repayment schedule;
- The prohibition of quoting variations in the base rate of consumer credit;
- The supply of more detailed commercial data. Improved credit statistics flowing from better disclosure will improve the regulatory parameters;
- A compulsory quote to be issued by the credit provider, which will be binding on the credit provider for five days (subject to there being no changes in the level of credit risk i.e. the consumer not having taken further credit in the interim);
- For small agreements, the quote and agreement must be in a standard, prescribed form in order to facilitate comparison;
- Misleading or fraudulent statements are prohibited and may be struck out by the court; and
- The content of adverts and marketing material is regulated, to prevent misleading advertisements.

To avoid over-regulation, the total disclosure document is in the form of a typical “health warning” (i.e. a one-pager) for most consumer loans.

The information sharing requirements is limited to:

- The creditworthiness (or rating) of clients can move with the client to a new creditor. This ruling is bound to increase competition.
- Consumers have a right to know why credit is being refused.
- Consumers have a right to access their credit bureau records once a year, free of charge.
- Credit providers will be able to share data through the National Credit Register.

The overall objective is to lift the regulatory standard to international minimum standards, and to protect the consumer. All of the Group of Ten countries have similar types of rulings as those mentioned in the National Credit Act. From an international perspective

these new rulings are normal, and are important for low-income consumers' understanding of the terms of loans, and critically important to lowering the cost of credit in the long term.

Disclosure is critically important for encouraging price competition. Full and comparable information about interest rates and fees will allow customers to compare prices for services. Empirical evidence shows that the result will be a reduction in the cost of credit and/or the improvement of services and product diversification. This is better than price controls.

5.1.2. The theoretical foundation of the legislation

Free market economy theory assumes perfect information for both producers and consumers. Transparent, comparable information on pricing facilitates competition on price. In practice, however, perfect information cannot be supplied free. Ultimately the marginal cost of more information must balance with the marginal benefit. Over-regulation (i.e. excessive demands on disclosure) must be avoided.

5.1.3. The expected costs of the legislation to consumers

The marginal costs of additional information are expected to be modest. In addition, more disclosure is bound to increase competition, which may result in a lower mark-up by credit suppliers. In such a case consumers will experience lower credit costs, not higher ones.

5.1.4. The expected risk of the legislation to producers

Disclosure and information-sharing regulations are bound to increase competition, which in turn may adversely affect the profitability of some credit suppliers. One of the aims of the National Credit Act is to reduce the level of reckless lending, and therefore creditors engaged in this type of business will be hurt. Note, however, that the capital requirements under Basel II are set at such a level that these inefficient producers (i.e. those who cannot compete on price) can leave the market without creating systemic risks.

Disclosure also has advantages for creditors, and particularly for lower-cost providers who want to gain market share, as weak disclosure benefits established players above newcomers.

5.1.5. Possible unintended consequences of the legislation

More disclosure and information sharing will benefit the consumer. However, severe competition between credit suppliers may lower profit margins so that their business becomes uneconomical in the short term. The market is bound to correct soon, however, as no enterprise can survive in the long run if the internal rate of return is structurally too low.

A final unintended consequence is that the onus on the banks to be sure clients have understood the terms of the credit effectively contributes to financial literacy. But the business of banks is selling credit, not education and thus the quality and focus of financial literacy may be a concern. As well as the need to ensure quality standards, financial literacy needs also to be supplied independently of the banks, as proposed by the Financial Services Board.

5.1.6. Conclusion

In principle the above proposed regulations seem correct, and they are critical to improve access to credit for lower-income earners and small and microbusinesses. In fact, this regulation is an important building block for improving competition, which should benefit low income clients. Possible teething problems have to be dealt with as more information becomes available.

5.1.7. Regulations and sections to abolish the Usury Act cap on interest rates

This section refers to the National Credit Act, Chapter 5, Part C, and the National Credit Regulations, Chapter 5.

5.1.8. The intention of the regulator

The Act abolishes the Usury Act and mainly replaces it with “reckless lending” regulation (see section 6.3. The current usury cap (fixed price) has been replaced with a “structured” cap (fixed margin) in line with European Union (EU) regulations. If a person lends money above the maximum allowable rate, the courts can force the creditor to reprice the loan.

Extreme cases of mis-pricing are common in South Africa, mainly as a result of:

- Low levels of consumer literacy;
- Weak competition;
- High demand for credit;

- Misleading disclosure;
- Deceptive advertisements (e.g. a bank slogan like: “We can loan you enough money to get you completely out of debt”); and
- Mechanisms that prevent consumer mobility (between providers), such as payroll deduction arrangements.

This exploitative pricing in turn results in reliable and trustworthy creditors withdrawing from the market segment that charges “seemingly exorbitant” rates. However, an APRC of more than 80% a year may well be reasonable for a small loan with a very short duration. A structured interest-rate cap will attract reliable creditors who in the past were afraid to be seen in the high-interest market for “reputation risk” reasons. With the proposed structured cap they can now service this market segment as well.

5.1.9. The theoretical foundation of the legislation

Economic theory does not generally favour price controls, at least if the market is not operating like a monopoly. Therefore, first prize in theory at least is to do away with any price ceiling and to improve the competitive forces in the market. In practice, the authorities have acknowledged that they need time to improve the competitive structure of the credit market. In the meantime, they have decided to use a price ceiling as an interim measure, despite the structural distortions and temporary reduction in credit services it may create in the short term. As soon as the effect of the reckless lending and disclosure provisions of the Act and the related regulations come into effect, and the National Credit Register becomes fully functional, it will be appropriate to remove the price controls.

5.1.10. The expected costs of the legislation to consumers

The amount of credit supplied at usurious rates is bound to decrease and the amount of mainstream credit for households should increase. But the empirical evidence of interest rate ceilings resulting in the retreat from more costly market segments is so strong in both developed and developing markets that the Regulator must assist in this transmission from the informal credit market to the mainstream creditors.

The critical question is whether there are any constraints outside of the ambit of the credit legislation on this shift from informal to formal market structures. These might include lack of collateral, distance to formal providers, etc. This is a separate research project, but one of great importance, requiring urgent attention by the authorities.

5.1.11. The expected risk of the legislation to producers

Those credit suppliers that now lend at rates well below the usury ceiling will be unaffected by the National Credit Act. Such lenders are more likely to experience an increase in their business, as predatory lenders are bound to struggle to keep their clientele.

Nonetheless there is likely to be an increase in cost of compliance for everyone, including “conservative” mainstream suppliers. Hopefully the reduced credit risk and the increased volumes that they can write will result in a net benefit for this category.

5.1.12. Possible unintended consequences of the legislation

The loan shark may become an endangered species in South Africa. Alternatively, loan sharks may look for totally new business fields, such as money laundering. Law enforcement agencies should take heed..

Another possibility is that the switchover from predatory to mainstream lenders will take too long. It is realistic to expect a “J” curve adjustment in the credit market after the new Act comes into full operation on 1 June 2007. During this period the currently over-indebted consumers and reckless lenders will withdraw from the market, i.e. prior to normality returning. If this down phase of the “J” curve takes too long, or if there is too little up-take from banks and other credit providers for “new credit”, there could be a political backlash.

Indeed if the interest rate caps create “a hostile financing environment” (see *Box 3: Interview with the Kuyasa Fund* on page 51) where lenders are unwilling to lend to low-income clients, this may mean a politically unacceptable contraction in access to credit and will have to be addressed urgently.

Box 3: Interview with the Kuyasa Fund

The Kuyasa Fund is a Cape Town-based non-profit organisation (generally regarded as a development microfinance institution) which uses microfinance as a tool to improve housing conditions for poor people in the Western Cape. It does this by supporting community groups to save towards housing and by granting loans to individuals qualifying for the state housing subsidy. It is Kuyasa's belief that access to savings enables households to build assets, not only in the form of housing but also by allowing capital to generate income, acquiring resources and smooth income flows (for details of the Fund visit their website at <http://www.thekuyasafund.co.za>).

Kuyasa provides microfinance services to those with secure occupational rights who are excluded from formal finance. For instance, their clients, who earn under R3,500 a month or are informally employed, are eligible for loans of up to R10 000 to improve their housing. Kuyasa's main objectives include providing finance to low-income clients who are not served by the formal finance sector; providing credit with the aim of improving housing and building social capital; and enabling clients to build adequately-sized houses that meet their needs.

Kuyasa draws its funding from a range of donors (the EU, USAID, the Culemborg Municipality, the Gilles Foundation, CORDAID, the Ford Foundation, EED and IBIS). For instance, its start-up wholesale finance, which was used to finance loans to clients, was obtained via a loan from the Urban Sector Network Opportunity Fund, which was back-funded by the Swedish International Development Co-operation Agency (Sida). However, over the last few years its dependency on grant funding has been decreasing as its financial sustainability has improved, and the organisation expects to be fully sustainable soon. Based on this, it has recently entered into discussions with the formal banking sector with an aim to securing long-term access to wholesale funds.

Interview with Olivia van Rooyen, manager of the Kuyasa Fund

The Kuyasa Fund lends to low-income (poor and very poor) clients for home improvements in the Western Cape with the twin objectives of improving the housing stock and providing clients with a good credit history for formal institutions. The Kuyasa Fund is providing loans for capital goods such as housing, and so has an important role in the provision of financial services for low-income clients.

Kuyasa cannot do mortgage financing because of land title problems in many cases, so its loans are essentially like consumer loans with group savings as collateral. Its current interest rate is below the cap in the new regulations, but the cost of capital is subsidised. Kuyasa is concerned that when it needs to borrow commercial capital, it will not be able to charge an interest rate that will cover costs. It is a small fund, working closely with its clients and does not have economies of scale like the big banks. The Kuyasa Fund's perspective is that the unintended consequence of the cap is that it will decrease access to loans for housing improvement by low-income clients and also decrease their access to the formal financial system.

Kuyasa pointed out that the new interest rate regulations create differences between allowable maximum rates based on formal sector definitions, so the fund does not fit into those categories. It feels there is a lack of awareness of the complexity of financing low-income clients.

Kuyasa is also concerned more generally that the interest rate caps will create "a hostile financing environment", where lenders will be unwilling to lend to low-income clients (i.e. even at an effective interest rate of 50% per annum or more).

5.1.13. Conclusion

Theoretically the regulation seems correct, however, empirical evidence shows that interest rate caps decrease access to credit by lower-income earners and small and micro-businesses. Since it is also a highly charged political issue, it would be prudent to wait until the reckless lending and disclosure regulations have taken effect, then remove the price controls.

5.1.14. Regulations and sections to avoid reckless lending and over-indebtedness

This section refers to the National Credit Act, Chapter 4, Part D, and the National Credit Regulations, Chapter 3, Part D (regulations 23-27)

5.1.15. The intention of the regulator

Reckless lending as a judicial concept is well known in countries like Australia, Belgium, the UK and the US. South Africa is trying to adjust to international standards in this respect. The principle of reckless lending is straightforward and states that (ideally) no additional credit should be granted to a person who is already over-indebted.

The problems with over-indebtedness are typically:

- Over-indebtedness and the debt-servicing burden reduce household disposable income; reduce household consumption, and household welfare;
- Over-indebted borrowers are less likely to meet municipal service payments, which in turn undermines local authority income and capacity;
- Over-indebted borrowers cannot make maintenance payments or meet any other personal social commitments;
- Defaulting borrowers get summonsed and receive default judgments. This impairs their credit records and in most cases would mean that they are denied access to conventional finance for many years;
- Consumers that have defaulted may not qualify for housing loans or other forms of conventional credit. They may be locked into “high risk / high cost” forms of finance, with the high cost of finance further undermining household welfare in the future;
- Social welfare payments received by households may well be diverted to serving high-interest loans; to meeting legal expenses related to opposing judgments; or to meeting payments that result from judgments having been granted. In each instance, the social grant had been diverted away from the intended purpose of

increasing the income and welfare of the beneficiaries. Rather than the targeted beneficiaries benefiting from such payments, financial institutions increase interest income, lawyers increase fees and debt collectors and debt administrators increase income; and

- To recover the losses from loans to defaulting borrowers, lenders have to increase interest rates on loans to the client base that do meet their commitments.

In short, without reckless lending rules society will increasingly be carrying the cost of reckless lending conduct elsewhere, whether through households that cannot survive on their social transfers, or municipalities that are not receiving the service payments. These costs are probably already high, but need to be quantified with some degree of urgency.

The regulator aims to reduce reckless lending, and reduce risk in the low-income market to:

- Increase entry of mainstream credit providers to enter this market segment;
- Increase provision of larger loans and longer-term loans to this segment (including housing loans in particular;)
- Facilitate a shift in products supplied to this market segment from high cost (short-term) products, to products such as credit cards; and.
- Increase availability of investor or capital market funding for institutions serving this market segment.

These changes will probably cause: 1. a diversification in products for low-income clients; 2. an increased supply of finance to low-income consumers; and 3. a reduction in interest rates for low-income consumers.

5.1.16 . The theoretical foundation of the legislation

Without distortions elsewhere in the economy, notably unequal access to the payment system, reckless lending would not occur so easily. As the credit markets become competitive and efficient, the scope for reckless lending is likely to decrease proportionally.

Over-indebted borrowers will always be a segment of the credit market. For instance, a sound mortgage loan can turn into an unsound one because of significantly higher interest rates (i.e. based on variable rate mortgage finance) or sudden loss of income (caused by *inter alia* retrenchment or illness). Over-indebtedness has to be avoided by lowering the degree of financial gearing.

5.1.17. The expected costs of the legislation to consumers

Currently lower-income earners are charged high borrowing rates because reckless lenders increase the probability of default in these income intervals to even higher levels (and because it is expensive to make small loans). By reducing the number of over-indebted borrowers, the default probability for all other borrowers will also fall. For proper borrowers the proposed legislation is favourable, while it is unfavourable for over-gearred or over-indebted borrowers.

5.1.18. The expected risk of the legislation to producers

The following could be expected:

- Lenders will inevitably change their loan products and lending approach towards clients that are seen to be likely to accumulate high debt servicing burdens; and.
- Risk-averse lenders (or “conventional mainstream providers”), may decide to avoid any market segment in which there is thought to be a risk of clients taking on high-debt burdens. This implies that the “high risk clients” would automatically be excluded from the products offered by such providers.

The implication is that any borrower group where high risk lending is common would be excluded from conventional and low-interest rate products. However, if the National Credit Register functions as it should, lenders will be able to rely on that information to decide about clients’ level of indebtedness and not exclude a whole group en masse.

5.1.19 . Possible unintended consequences of the legislation

Reckless lending is a judicial term and its precise definition has not been tested in the courts. In time there may be some small surprises. There may be increased interest in promoting savings and other financial services such as insurance, instead of credit – which would be a positive outcome. If the courts have an extremely conservative interpretation of over-indebtedness, this could create a risk for lending at even normal debt-servicing levels.

Another unintended consequence may be that the reckless lending penalty causes the mainstream lenders to avoid the low-income market altogether. This would be a real problem²⁸. It might also hit specialist microfinance service providers if they are afraid that the courts/sheriff will not help them take action against a delinquent client.

²⁸ Except to mention that some large mainstream creditors are still avoiding the low-income market, except for their micro-loan products at very high rates.

5.1.20. Conclusion

In principle, the above regulation seems correct, and it is unlikely that this piece of legislation in itself will limit access to credit by lower-income earners or small and microbusinesses.

5.2. Sections to establish a National Credit Register

This section refers to the national Credit Act, Section 69 read with Schedule 3, item 3.

5.2.1. The intention of the regulator

The regulator is keen to address the following problems with existing credit bureaux:

- The non-sharing, or insufficient sharing, of credit information between credit bureaux.
- Substantial inaccuracies in existing credit bureau information.
- Significant public information not being disseminated to the credit providers (e.g. judgments, maintenance, and service payments).
- Problems in matching credit information with the identity of consumers resulting in misclassifications (inconsistent information exchange between bureaux and the Department of Home Affairs).

The establishment of a National Credit Register is badly needed in South Africa. Similar institutions are well established in many developed countries, and for similar good reasons.

Without a register it is difficult to see how to overcome the weaknesses in credit information, and how this information base could enable credit providers to objectively determine whether borrowers are over-extended. Furthermore, the National Credit Register will allow good borrowers to build a strong credit history that is accessible to competing lenders.

5.2.2. The theoretical foundation of the legislation

Any instrument that improves information flows is favoured in economic theory. However, it must be accurate and up-to-date to be useful.

5.2.3. The expected costs of the legislation to consumers

If the establishment of National Credit Register is R30-million and the number of credit accounts is 19 million, the discounted costs per transaction is estimated to be around R3.

Owing to the expected increase in competition, which flows directly from the establishment of a National Credit Register, it is unlikely that the APRC will increase.

5.2.3. The expected risk of the legislation to producers

The National Credit Register will improve information sharing and thus risk management procedures for lenders. However, it will also result in more competition between credit bureaux as key information becomes more readily available. The ultimate risk for lenders (and credit bureaux) is lower profitability, as increased competition is bound to put pressure on the mark-up component of the APRC.

However, the National Credit Register will not be able to achieve any of these goals if it does not have full, accurate and up-to-date information. The lenders will be making decisions on inaccurate information.

5.2.4. Possible unintended consequences of the legislation

Viewing the experience of the various industrialised countries that operate similar national credit registers, no negative effects are to be expected.

5.2.5. Conclusion

The sections of the Act to establish a National Credit register seems correct. It is unlikely that this piece of legislation in itself will limit access to finance by lower-income earners or small and microbusinesses.

5.3. Regulations and sections to enhance debt rehabilitation and debt counselling

This section refers to the National Credit Act, section 44, sections 46-47, Chapter 4, part D (sections 78-88) and Chapter 6; and to the National Credit Regulations Chapter 2, Part C regulations 10-11 and Chapter 3, Part D (regulations 23-27).

5.3.1. The intention of the regulator

Enormous hardships typically flow from over-indebtedness and debt default. The National Credit Act envisages social support in the form of debt counseling for those needing debt rehabilitation. In most developed countries this type of service is available and paid for by either the State or industry.

5.3.2. The theoretical foundation of the legislation

Debt counselling is a form of consumer education and thus information transfer. Debt rehabilitation will be similar to the current administration orders being granted against individuals in terms of section 74 of the Magistrates' Act Court Act 32 of 1944. A debtor who is unable to pay his debts may apply for an administration order, provided that his or her debts do not exceed R50,000. When such an application is granted, the debtor must make regular payments to an administrator. The administrator is obliged to draw up a list of creditors and must pay them from the amounts received from the debtor. The main difference between an administration order and debt rehabilitation is that the person will deal with debt counsellors, not administrators and that administration orders can be granted only for individuals whose debts do not exceed R50 000. These services are bound to improve the workings of the credit market as debtors become more informed players.

5.3.3. The expected costs of the legislation to consumers

Lenders are likely to recover the costs incurred from their clients by charging them against operating costs. As a percentage of the APRC these costs are likely to be miniscule.

5.3.4. The expected risk of the legislation to producers

The risk to lenders is that the standard of debt counsellors may not be adequate and they may not be properly monitored. This would mean that clients would not be well informed about how they stand with the lender. This could result in the debt counsellor making ill-informed decisions about reckless lending or about the client's ability to pay.

5.3.5. Possible unintended consequences of the legislation

The major unintended consequence is that the focus is on debt rehabilitation rather than preventing over-indebtedness. Prevention is a much better than cure and consumer financial education is a public good (Vision 2010).

Debt restructuring orders are similar to the current administration orders. Unexpectedly, and probably due to the prolific growth in the microlending industry, administration orders have become extremely popular over the last decade. In practice, many administration orders fail as debtors do not maintain regular payments. Even if debtors do pay regularly most of the payments go into the administrators' pockets as "fees". Little ends up being paid to creditors to reduce the debts. There are neither set minimum requirements that administrators need to comply with, nor is there any regulatory body governing administrators. The procedure also does not provide for a discharge of debts. An administration order lapses only once the costs of the administration and the listed creditors have been paid in full. As section 74 of the Magistrates' Court Act has no provision for the repayment of the debt within a fixed time limit, many debtors remain in a debt trap. This is compounded by *in futuro* debts, that is debts that are payable by means of future instalments due in terms of an existing and enforceable contract, are excluded from the administration procedure. In the end the procedure thus amounts to nothing more than a formal rescheduling of debt.

It is also commonly believed that unscrupulous administrators are holding unexpected consumer-debtors to ransom and that these debtors will never escape their financial problems. There are indications in the market that many individuals who have to rely on microlenders end up under the administration regime, which in its current form aggravates their debt situation rather than affording real relief. Even though the Micro Finance Regulatory Council was established in 1999 to accredit lenders and monitor their behaviour, problems persist.

These and other complaints have prompted the Department of Justice to implement a reform project. This led to the South African Law Reform Commission appointing a Project Committee during 2003 to make formal proposals on the reform of administration orders. However, as the debt restructuring orders and debt counselling provided for in the National Credit Act and its regulations will have an effect on administration orders, the Project Committee has placed its reform on hold until the full force of these sections and regulations of the Act come into operation during 2007.

Debt restructuring orders will only be effective if all the pitfalls and problems with administration orders are addressed. The relevant sections and regulations of the

National Credit Act do address most of these problems. However, one concern is that no clear provision has been made for the regulation of the fee structure of the debt counsellors. It is also not clear who will be responsible for paying these counsellors. The hope is that the requirement that debt counsellors must be registered with the National Credit Regulator and have to comply with certain minimum requirements will provide some protection.

5.3.6. Conclusion

In principle the debt counsellors regulation seems correct but it is only a partial solution. It is unlikely that this piece of legislation in itself will limit access to finance by lower-income earners or small and microbusinesses. However, it would enhance the regulation if the Policy Board on Financial Services became more proactive in promoting its National Strategy for Financial Literacy.

5.4. Sections to restrict the National Credit Act mainly to natural persons

This section refers to the National Credit Act, sections 4 and 5.

5.4.1. The intention of the regulator

The focus of the National Credit Act is primarily the retail market. Wholesale markets are far more sophisticated and thus are more likely to be able to look after their own interests. However, although the main objective is to protect consumers as individuals, it also applies in a more limited sense to companies, close corporations, partnerships, certain trusts and other associations and bodies of persons, provided their asset value or annual turnover is lower than R1,000,000 (see section 4 of the Act). For instance, the provisions relating to reckless lending and over-indebtedness, and also the provisions limiting the interest rates and other costs of credit, will not apply when the consumer is one of these small and medium businesses (see section 6 of the Act). This means that lenders may charge any interest rate and other costs of credit when they conclude credit agreements with these small and medium businesses, without having to fear that such an agreement might be declared a reckless lending transaction. Remember also that if such a business consumer with an asset value or annual turnover lower than R1 000 000 concludes a large credit agreement, for example concludes any mortgage agreement or a credit transaction or signs a credit guarantee for an amount equal or above R250 000, the Act will not apply to THAT large credit agreement (see section 4(1)(b)).

5.4.2. The theoretical foundation of the legislation

Differentiating between natural persons and the other entities described above is logical, as regulatory theory always make as a distinct difference between the wholesale and retail markets. “A one size fits all” philosophy has to be avoided on cost-benefit grounds.

5.4.3. The expected costs of the legislation to consumers

None.

5.4.4. The expected risk of the legislation to producers

None.

5.4.5. Possible unintended consequences of the legislation

None.

5.4.6. Conclusion

In principle, the above regulations seems correct, and it is unlikely that this piece of legislation in itself will limit access to credit by lower-income earners or small and microbusinesses. Possible teething problems have to be dealt with as more information becomes available.

5.5. Regulations and sections to improve debt collections and dispute resolutions

The section refers to the National Credit Act, Chapter 2 Part B, Chapters 6 and 7; and the National Credit Regulations, Chapter 6.

5.5.1. The intention of the regulator

One of the big problems for consumers, regulators and the courts is the “race to court” by debt collectors. The aim of the new Act is to isolate reckless lending from proper lending, to subordinate predatory lending to all other credits, and to suspend interest payments if reckless lending is proven. With these stipulations the regulator hopes to reduce significantly the ever-popular “race to court” by debt collectors.

5.5.2. The theoretical foundation of the legislation

The regulations on debt collection and dispute resolutions are judicial in nature.

5.5.3. The expected costs of the legislation to consumers

None.

5.5.4. The expected risk of the legislation to producers

Bad debt of predatory lenders and other irresponsible creditors may rise steeply, which may ultimately mean default for these types of creditors. If a loan is extinguished or subordinated by the court, the debt collector's work will fall accordingly.

However, responsible creditors are likely to face increased collections, as the bad apples are removed from the fruit basket.

5.5.5. Possible unintended consequences of the legislation

Bad debt may well rise to higher levels than initially expected by the regulators. Clearly, the chance exists that some blood may be spilled. As the saying goes: "Running into debt isn't so bad. It's running into creditors that hurts."

5.5.6. Conclusion

In principle the above regulations seem correct, and it is unlikely that this piece of legislation in itself will limit access to finance by lower-income earners or small and microbusinesses. Possible teething problems have to be dealt with as more information becomes available.

5.6. Regulations and sections to improve law enforcement

This section refers to the National Credit Act, Chapters 2, 4 and 8; and to the National Credit Regulations, Chapter 2 Part D, and Chapter 3.

5.6.1. The intention of the regulator

Any law is as good as its enforcement. Enforcement of the National Credit Act will be improved in the following ways:

- The creation of a new super-regulatory structure, which embraces all aspects of consumer credit in the retail markets. The Office of the MFRC) has been incorporated within the Office of the newly established National Credit Regulator.
- The courts will have increased powers under the Act.
- The Act gives new rights to debtors, which in turn enable these debtors to seek justice in the courts.
- The Tribunal will be established to hear cases against creditors who are suspected of contravening the legislation, avoiding the kinds of delays now in the overburdened courts.

5.6.2. The theoretical foundation of the legislation

The enforcement of law is crucial to the working of a free market economy.

5.6.3. The expected costs of the legislation to consumers

None.

5.6.4. The expected risk of the legislation to producers

None.

5.6.5. Possible unintended consequences of the legislation

None.

5.6.6. Conclusion

In principle the above regulations and the sections of the Act seem correct, and it is unlikely that this piece of legislation in itself will limit access to finance by lower-income earners or small and microbusinesses. Possible teething problems have to be dealt with as more information becomes available.

5.7 Related legislation: Regulation to ensure access to the National Payment System

This section refers to the National Payment System Act.

5.7.1. The intention of the regulator

It is unfair that there is queue jumping in the National Payment System. Banks that can prioritise their claims ahead of others in the National Payment System clearly have a unfair advantage, and that results in many other distortions in the credit market, particularly if this advantage is “for sale” to associates. Anyhow, ensuring equal access to the National Payment System has already been agreed on by all participants in the credit market (i.e. the SA Reserve Bank and the Banking Council). Irrespective of further developments in the National Credit Act, the SA Reserve Bank will try to ensure that equal access will be enforced in the near future.

5.7.2. The theoretical foundation of the legislation

No argument could be found in the financial literature that banks have a natural, favoured position when it comes to debt collections.

5.7.3. The expected costs of the legislation to consumers

None.

5.7.4. The expected risk of the legislation to producers

For the established banks, equal access to the National Payment System may imply a major cost, as a significant amount of credit was perhaps based, and priced, on the underlying assumption that they could jump the queue forever. Quantifying this loss needs co-operation of the banking sector, which is unlikely soon. Hence, there is a need for a public enquiry (see Section 6.3). However, if the banks can understand that this is a *fait accompli* and comply promptly, they might generate some good will.

5.7.5. Possible unintended consequences of the legislation

Depending on the amount of loans affected, bad debt for some banks may rise significantly. In the extreme (highly improbable) case it may even cause a bank default. The Registrar of Banks needs to keep a watchful eye on developments. But irrespective of the unintended consequences (e.g. bank default), equal access to the National Payment System is crucial and will be enforced.

5.7.6. Conclusion

In principle equal access to the National Payments System is crucial. It will enhance the access to savings services by lower-income earners or small and microbusinesses. In fact, equal access to the payment system should also expand financial institutions' ability to design better financial products for their low-income clients.

6. ACCESS TO FINANCE BEYOND CREDIT

6.1. Viability of narrow banks and core banks in the Dedicated Banks Bill

The proposed Dedicated Banks Bill of 2004 for second-tier banks distinguishes between "Narrow Banks" and "Core Banks". Narrow banks are compelled to invest all their deposits in highly liquid (mainly Government) paper, while core banks are allowed to finance loans with debentures but NOT depositors' money. This section looks at the possible impact of the National Credit Act by viewing each of these banking institutions in isolation.

As narrow banks make no loans of any form, the National Credit Act will by-pass these types of institutions. As proposed in the Bill, the main business of a narrow bank will be the investment of retail savings in Government (and money-market paper) and money transmission. Apart from the Post Bank's important role, narrow banks offer opportunities to expand savings and transfer services and are thus an interesting option for innovative entry into the financial market, as shown by MTN Banking (a division of Standard Bank) which could have set up as a narrow bank if the legislation had existed.

MTN Banking is not registered in terms of the Bank Act, but is allowed to function as a bank because it is a division of Standard Bank, which is registered in terms of the Banks Act. It is also not MTN Banking that takes the deposits, but Standard Bank.

WIZZIT is not registered as a bank in terms of the Banks Act, but it operates as a division of the South African Bank of Athens, which in turn is a division of the Bank of Greece. The South African Bank of Athens is registered as a bank in terms of the Banks Act, and because WIZZIT is a division of this bank, it is allowed to function as a bank. It is also not WIZZIT that takes the deposits. It has deposit-taking agreements with the Post Office (2 600 branches) and Absa (800 branches).

Companies that may be interested in a core bank license²⁹ are:

- **Cellphone companies.** Their commercial interest is money transfers and the national payments system. It is unlikely that the granting of retail loans will be a significant part of their business plans.
- **Retailers.** Their commercial interest is consumer loans, credit card business, and money transfers, and thus by implication the national payment system. Retailers are already involved on a massive scale in consumer loans and the granting of credit through in-house credit cards. These companies mainly fund their own credit operations (i.e. depositors' money will not be used for such credit transactions). The advantages of obtaining a second-tier banking licence is anchored in the following:
 - Access to the Interbank Funds Market (to obtain the finest refinancing rates for their consumer credit).
 - Access to the National Payment System (to ensure competitive prices in money-transfers for clients).

Competitive forces will probably force retailers to either obtain a second-tier banking license or to engage in a commercial partnership with a bank. The National Credit Act is aimed at retailers, especially their current operations, for example in providing credit, and will influence their current businesses. They also need to register as credit providers if they have more than 100 credit agreements or have outstanding loans amounting to R500,000.

- **Microlenders.** The commercial reasoning for microlenders to apply for second-tier banking licences is similar to those of the retailers. Their commercial interest is a level playing field with their main competitors, and particular the banks.
- **Insurers.** The commercial reasoning for insurers to apply for a second-tier banking license is access to another means to collect premiums and pay claims.
- **Banks.** Banking groups are likely to create second-tier banking subsidiaries for defensive reasons. Although a first-tier bank may do everything that a second-tier bank can do, there are competitive advantages in facing the competition from other second-tier banks on a level playing field, particularly in the statutory capital requirement. Banks will be affected by the National Credit Act because they are such big players in the microfinance market. However, it is unlikely that the National Credit Act will influence decisions to create second-tier banking subsidiaries.

²⁹ For a more detailed discussion see Hawkins (2005) "The impact of the Dedicated Banks Bill on Access to Financial Services".

The National Credit Act is bound to have a major impact on the banking industry. It is unlikely to affect, however, the choice of whether a banking group would like to have, or not have, a second-tier banking subsidiary. The appeal of a second-tier banking licence mostly related to competitive issues.

6.2. The proposed Co-operative Banks Bill and access to credit

The draft Co-operative Banks Bill³⁰ was compiled around the same time as the draft Dedicated Banks Bill of 2004. The Co-operative Bill was based on substantial research around the potential in the market³¹ and various versions of the Co-operative Banks Bill were discussed before the current draft Bill was finalised.³² An investigation into the costs associated with the regulation of co-operative banks was also undertaken.³³

The Co-operative Banks Bill aims to open the way for co-operatives registered in terms of the Co-operative Act of 2004 to provide banking services. The Co-operative Banks Bill, as with the Dedicated Banks Bill, also aims to improve access to financial services. The Co-operative Banks Bill provides for the regulation and development of existing community banks (e.g. village banks) and to promote new co-operative banks. The hope is that this Co-operative Banks Bill will create an enabling environment for co-operative banks, which would then be integrated into the formal banking system either as “Narrow” (Savings Co-operative Banks) or “Core Banks” (Savings and Loans Co-operative Banks). Another hope is that by licensing interested co-operative banks, the consequent provision of financial services will improve access to financial services for the broader market. However, since the first publication this draft Bill, there has been little further development.

6.3. Beyond Credit

The vision of those working to improve poor people’s access to financial services is an “Inclusive Financial System”. This is a financial system where a continuum of financial institutions together offer appropriate products and services to all segments of the population, supported by a sound policy, legal and regulatory framework (UNCDF 2006). Consumer credit is only one aspect of an inclusive financial system. Savings services are

³⁰ This bill was published and has been introduced to Parliament as Bill 4 of 2005.

³¹ For a full discussion of the report that preceded the drafting of this Bill see Coetzee Gerhard, Schoeman Jan and Willemse Rudolph (2003) “Member Based Financial Institutions: A review of the capacity, lessons learned and the way forward for member-based financial institutions” ECI report prepared for Finmark Trust (25 July 2003).

³² For a full discussion of comparison between the proposed Bill that was submitted to Treasury and the draft Bill that was eventually published by Treasury, see Willemse Rudolph (2005) *Evaluating the Co-operative Banks Bill through the Finmark Lens*, a report prepared for the Centre for Micro Finance, 5 March 2005, University of Pretoria

³³ See Coetzee Gerhard, Schoeman Jan and Willemse Rudolph (2003) *Design and feasibility of regulation and support structure*, ECI report prepared for Finmark Trust, November 2003

equally, if not more, important for low-income clients, as are transfer services and insurance. These broader issues are not central to this study but, there are three points worth noting that are critical to building an inclusive financial system:

6.3.1. Access to the National Payments System

The proposed Dedicated Banks Bill and Co-operative Banks Bill will require the four tier-one banks to relinquish their monopoly on the national payments system so that tier-two and tier-three banks can participate. This is critical for the small saver to access savings. The tier-one banks' monopoly is creating high barriers to savings services. But these important Bills seem to be in limbo for the moment. The *Competition in Banking* report in 2004 suggested there might be a “complex monopoly” in South African banking, and recommended further investigation of the national payments system. There is also the public inquiry into bank charges.³⁴ Opening up the payments system would be a great step towards increasing access to savings and other payment services by low-income clients. See *Box 4: How access to the payments system prevents poor people from access to deposit systems*

³⁴ The Competition Commission's hearings into banking fees is set to begin in November 2006 and the final report on its findings is expected to be submitted in June 2007. The understanding is that two rounds of public hearings will be held – the first in November 2006 and the final round during March and April 2007. The deadline for written submission by interested parties is 27 October 2006 (see Legalbrief Today, *Competition: Inquiry into bank charges gets under way* (Newsletter of Wednesday 23 August 2006) (at <http://www.legalbrief.co.za>) (last visited on 28 August 2006).

Box 4: How access to the payments system prevents poor people from access to deposit systems

The fees charged by South African banks are among the world's highest and stand in the way of more South Africans entering the formal banking system. (Gunion 2006) "The retail part of the [national payment] system, which involves the banks and the point of sale or ATM interface, is to a large extent privately owned and managed."

In other words, the major banks control entry to the system. The banks argue that they have invested large sums in the underlying technology, and they are reluctant to share the benefits with others, unless they are paid large sums. However, that money was invested in the 1980s. The entry fees to the national payment system keep new competitors out, allowing the established banks a free hand in pricing.

The main victims are those who can't afford to bank. People who earn small, irregular amounts can't pay the fees levied on banking transactions. This excludes millions of people from participating in the mainstream of the economy. *Access to transaction banking would give these people access to much-needed financial services, such as low-cost insurance, which is an invaluable shield against adversity.*

If access were more affordable, not only the poor would benefit. The deeper the flows through the regular financial system, the better for bankers. Drawing more people into the formal economy would have benefits for all.

The Dedicated Banks Bill, published in 2004, is intended to open the way for different types of companies, such as retailers and cellphone firms, to provide banking services, but the Bill is in limbo and the cost of participating in the national payment system is seen as an obstacle to new entrants.

Co-operatives wanting to provide banking services in line with the Co-operative Banks Bill and participate in the national payment system face the same obstacles. According to the Feasibility report, the information needed to quantify costs is not published by the banks, and any link between the operating costs associated with a transaction and the fee the bank charges is not transparent.

"It may be that bank fees have less to do with the cost of the payment system and more to do with the market power of banks in setting their fees," the report says. This no doubt explains why a public inquiry is deemed necessary.

Consumers will benefit from an inquiry into bank charges – Business Report
April 21, 2006 By Ethel Hazelhurst

6.3.2. Consumer Financial Education / Financial Literacy

Consumer financial education aims to teach consumers of credit about being responsible borrowers. Financial literacy refers to the knowledge, skills, and attitudes required for good money management practices for earning, spending, saving, borrowing, and investing.

Financial literacy programme participants receive information and tools to help them make better financial choices, work towards their financial goals, and improve their economic well-being. For poor people, good money management is a daily challenge.

Pressures on cash flow are persistent and often urgent. Financial education builds the capacity of the poor to control their finances, become proactive, and use information and resources to enhance their economic security.

In the 2002 Financial Sector Charter, banks committed to providing 0.2% of post-tax profit for consumer education. A 2004 ECI*Africa* study for FinMark Trust on the scope of financial literacy in South Africa concluded that South Africa remains underserved by programmes offering financial education, and the banks had a long way to go to keep to this commitment. This study recommended that banks support the National Strategy for Financial Literacy of the Financial Services Board. Building on this work, FinMark Trust (2005) developed eight principles that need to be observed if the consumer education goals of the Charter are to be effective. These still need to be addressed in full.

The National Credit Act, the proposed Dedicated Banks Bill and the Co-operative Banks Bill together address the structural problems of the financial sector. When the Deposit Insurance Act (to protect small savers)³⁵ becomes a reality, it will also address these problems. What is needed now is to educate clients so they can fully participate in an inclusive financial system

6.3.3. Research on access to financial services.

Access to a wide range of financial services for the majority of the population remains a challenge. This was a key goal of the Financial Sector Charter. The annual report required by the National Credit Regulator on access to credit is an important first step. However a Technical Committee responsible to an interdepartmental body from all the relevant government agencies and/or an independent research group needs to be commissioned to describe the vision for building an inclusive financial system, and to make recommendations on how to achieve this to the SA Reserve Bank, the Financial Services Board, dti, and other relevant agencies.

³⁵ It is understood that the Minister of Finance is considering proposals to create a Deposit Insurance Act. A draft Deposit Insurance Bill has apparently been drafted, but it is not in the public domain yet. The objective of such an act will be to protect the deposits made by small savers in, for example, village banks.

7. CONCLUSION

The National Credit Act (2005) and Regulations (2006) aggressively address problems in the South African credit market. An adjustment phase for financial institutions, clients and the new Regulator is needed as the full force of this new law takes effect. Price controls are not an optimal mechanism for managing credit costs and as soon as the reckless lending and disclosure regulations take effect (1 June 2007), they should be lifted. To complement the Regulator's work of monitoring market development, an independent assessment of improvements in access to credit is needed from the microcredit clients' perspective. In particular, it should address whether there are any constraints outside of the ambit of the credit legislation on this shift from informal to formal market structures. To enable a benchmark to be established, this should be commissioned now. Debt counsellors are important, but preventing over-indebtedness is equally as important. The Regulator and the credit industry should work with the Financial Services Board to support its national strategy for financial literacy. Finally, the broader challenge of access to a wide range of financial services, including savings and insurance, for the majority of the population remains. With many of the credit market problems being addressed by dti, a forward-looking vision for building an inclusive financial system is needed that includes the SA Reserve Bank, the Financial Services Board, dti and other relevant agencies.

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Government Gazette No 28893 of 1 June 2006 General Notice 173 "Determination of thresholds"

Magistrates' Courts Act 32 of 1944

National Credit Act 34 of 2005 (published in Government Gazette 28619 of 15 March 2006)

National Credit Regulations of 2006 (published in Government Gazette No. 28864 of 31 May 2006, Vol 491, Regulation Gazette 8477, R489)

National Payment System Act 78 of 1998

Usury Act 73 of 1968

APPENDIX 1: MAIN COMPONENTS OF THE NATIONAL CREDIT ACT AND REGULATIONS

1. Main components of the National Credit Act

The National Credit Act consists of 173 sections grouped under nine chapters:

- Chapter 1: Interpretation, Purpose and Application of the Act;
- Chapter 2: Consumer Credit Institutions;
- Chapter 3: Consumer Credit Industry Regulation;
- Chapter 4: Consumer Credit Policy;
- Chapter 5: Consumer Credit Agreements;
- Chapter 6: Collection, Repayment, Surrender and Debt Enforcement;
- Chapter 7: Dispute Settlement Other Than Debt Enforcement;
- Chapter 8: Enforcement of Act; and
- Chapter 9: General Provisions.

Chapter 1: Interpretation, Purpose and Application of the Act

Chapter 1 of the National Credit Act sets out: the definitions of certain words and terms used in the Act; the purposes of the Act; and the exact application of the Act (see sections 1–11).

Section 3 sets out the specific purposes of the Act. The Act's overarching purpose is to create a single system of credit regulation and a National Credit Regulator to administer the credit industry. It seeks to promote and advance the social and economic welfare of South Africans, and to promote a fair, transparent, competitive, efficient and accessible credit market for all South Africans, particularly those who have historically been unable to access credit under sustainable market conditions. It also aims to prohibit unfair credit and credit marketing practices and to protect consumers. A further objective is to encourage responsible borrowing, avoidance of over-indebtedness and reckless lending, and to provide a consistent, harmonised system of debt restructuring, enforcement and judgement.

Section 8 of the Act provides that, subject to certain exemptions, the Act applies to all credit agreements. An agreement will be a credit agreement for the purposes of the Act, if two elements are present, namely:

- some **deferral of repayment or prepayment**; and

- there is a **fee**, charge, or **interest** imposed for a **deferred payment** or a **discount** is given when **prepayments** are made.

The Act also distinguishes three categories of credit agreements:

- a credit facility (for example a credit card);
- a credit transaction (for example an instalment agreement or a mortgage agreement); and
- a credit guarantee (for example a suretyship).

The definition of a credit agreement excludes an insurance policy; a lease of immovable property and a transaction between a stokvel and a member of that stokvel in terms of the rules of the stokvel.

Furthermore, to subdivide the market by size and to facilitate effective regulation, the Act in section 9 provides for three classes of credit agreements namely, small³⁶, intermediate³⁷ and large agreements.³⁸ The classification of a credit agreement as small, medium or large, will depend on the thresholds determined by regulation and the type of agreement involved (see Government *Gazette* 28893 of 1 June 2006 GN 713).

Although the Act applies mainly to credit agreements in which the consumer is an individual (i.e. a natural person), it also applies to a credit agreement where the consumer is a company, close corporation, partnership, a trust where there are three or more individual trustees or the trustee is itself a juristic person, or any other association or body of persons irrespective of whether or not it is registered in terms of any act, provided its asset value or annual turnover, at the time the agreement is made, is lower than R1,000,000.³⁹ The Act, however, has limited application when the consumer is one of these businesses. The provisions about reckless lending and over-indebtedness, and also the provisions limiting interest rates and other costs of credit, will not apply when the consumer is one of these small and medium businesses (see section 6 of the Act).

³⁶ A credit facility where the credit limit falls above R15,000 or a credit transaction where the principal debt falls between R15,000 and R250,000.

³⁷ A credit transaction and the principal debt under that transaction fall at or above R250,000. A credit facility (e.g. credit card) cannot be a large agreement. All mortgage agreements are large agreements.

³⁸ However, if such a business consumer with an asset value or annual turnover equal or below R1,000,000 concludes a large credit agreement, for example concludes any mortgage agreement or a credit transaction or signs a credit guarantee for an amount equal or above R250,000, then the National Credit Act will not apply to THAT large credit agreement (see section 4(1)(b)).

Chapters 2 and 3: Consumer Credit Institutions and Consumer Credit Industry Regulation

On 1 June 2006 the National Credit Act established a National Credit Regulator responsible for the regulation of the South African credit industry (see sections 12–25). The Regulator is tasked with education, research, policy development, registration of industry participants, investigation of complaints, and ensuring enforcement of the Act. The Regulator is required to promote the development of an accessible credit market, in particular to address the needs of historically disadvantaged persons, low-income persons, and remote, isolated or low-density communities. The Regulator is also tasked with the registration of credit providers⁴⁰ credit bureaux and debt counsellors (see sections 39–52); cancellation or suspension of the registration of credit providers, credit bureaux and debt counsellors (see sections 54–59); dealing with complaints; promoting alternative dispute resolution; and enforcement of compliance with the Act.

The Act also provides that certain functions of the National Credit Regulator be performed by parallel entities in those provinces that have established such bodies. It also provides for the Minister of Trade and Industry to delegate functions of the Regulator to Provincial Members of the Executive Council in those provinces that have not established or choose not to establish self-standing provincial entities.

The Act also provides for the establishment of a National Consumer Tribunal on 1 September 2006 (see sections 26–34). The Tribunal will be an independent body, separate from the National Credit Regulator, with members appointed by the President. It will adjudicate in a wide variety of applications and will be responsible for hearing cases against credit providers that contravene the Act. The body will also be empowered to issue fines when it is deemed necessary. In addition to its powers to adjudicate disputes directly, the Tribunal will have the authority to make a consent order reflecting any resolution arrived at through an alternative forum and/or issue a compliance notice. Credit providers and consumers may appeal to the Tribunal against decisions of the National Credit Regulator.

Chapter 4: Consumer Credit Policy

Chapter 4 deals with consumer credit policy. It sets out the rights of a consumer. This includes the right: to apply for credit; to not be discriminated against when applying for

⁴⁰ Credit providers are required to register with the National Credit Regulator if they have concluded at least 100 credit agreements to which the Act applies (other than incidental credit agreements); or the total principal debt of all outstanding credit agreements concluded by the credit provider to which the Act applies (other than incidental credit agreements) exceeds R500,000.

credit; to be given reasons as to why a credit application was refused or why lower credit was given; to information in one of the official languages of South Africa;⁴¹ to information in plain and understandable language; to receive documents; and to protection of all consumer rights (see sections 60– 66).

The chapter also provides for the confidential treatment of a consumer's personal information and his credit records. For example, information given to a credit provider must be treated as confidential and used only for the purpose permitted or required by the Act or other legislation.

The Act also provides for the regulation of consumers' credit information being held by credit bureaux. It places specific duties on credit bureaux for consumer credit information obtained and retained by such bureaux, and for the consumer's right to inspect and challenge the correctness of the records.

Section 69 of the Act also provides for the creation of a National Register of Credit Agreements. This section states that the Minister of Trade and Industry may require the Regulator to establish such a register. However, although the section establishing this Register has come into operation, it will only become effective once it is created by the Regulator and an independent auditor has "approved and confirmed" that the Register will be able to receive and compile the required information. In other words, the "physical" coming into operation of the Register has been delayed.⁴² As soon as this Register is established, credit providers will be required to submit certain information (for example the name of the consumer and his identity number, the credit limit under a credit facility, or the principle debt outstanding under a credit agreement and the amount of the monthly instalments payable) to the Register when they enter into new credit agreements or amend current credit agreements. They will also be expected to supply certain information about the credit agreements that were concluded before the Act came into operation.

Chapter 4 also contains the provisions providing for allowable credit marketing practices (see sections 74–77). For instance, credit agreements cannot be marketed on the basis that an agreement will automatically come into existence unless the consumer declines the offer. Furthermore, any solicitation by a credit provider to induce a person to apply for credit must include a statement with prescribed information, depending on the type of

⁴¹ Section 63(1) of the National Credit Act provides that: "A consumer has a right to receive any document that is required in terms of this Act in an official language that the consumer reads or understands, to the extent that is reasonable having regard to usage, practicality, expense, regional circumstances and the balance of the needs and preferences of the population ordinarily served by the person required to deliver that document."

⁴² See schedule 3, item 3 of the Act.

solicitation. Certain advertising practices are also regulated by the Act. For instance, when an advertisement makes reference to a specific credit product full disclosure of the costs of credit such as interest rates and instalments payable must be made.

Sections 78–88 of Chapter 4 contain provisions aimed at protecting consumers against over-indebtedness and reckless granting of credit by credit providers. These provisions do not apply if the consumer is a juristic person as defined in the Act (i.e. a company, close corporation, partnership, a trust, or any other association or body of persons irrespective of whether or not it is register in terms of any act, provided its asset value or annual turnover, at the time the agreement is made, does not equal or exceed R1,000,000). This means that only natural persons enjoy the protection of these provisions.

The Act makes provision for a consumer to apply to a debt counsellor for a review of his debt or to a court so that it can refer the matter to a debt counsellor. The debt counsellor must also notify all the credit providers that are listed in the application for debt review, as well as every registered credit bureau, of the review application. The credit provider must comply with any reasonable requests by the debt counsellor to facilitate the evaluation of the consumer's indebtedness. The debt counsellor must determine whether any credit agreement concluded by the consumer is reckless and make the appropriate recommendation to a relevant court.

Chapter 5: Consumer Credit Agreements

Chapter 5 deals with credit agreements, such as the disclosure required before an agreement may be concluded, the form of the agreement, and the cancellation, rescission or alteration of a credit agreement. The Act also circumscribes what time periods for statements of the credit agreements must be provided. This varies according to the type of credit agreement.

The Act stipulates when a credit agreement will be deemed unlawful. For example, a credit agreement will be unlawful when the credit provider concluded it with an unassisted minor or a mentally unfit person. The Act also stipulates that a credit agreement must not contain unlawful provisions, and provides a list of these. For example, it is unlawful for a consumer to authorise the credit provider to do anything that is unlawful under the National Credit Act.

In various instances, the Act provides that certain documents (for example pre-agreement statements and quotations (see section 92)), copies of the credit agreements (see section 93) and statements of accounts (see sections 108-110) should be provided to consumers.

The Act specifically requires a credit provider to supply a consumer with a pre-agreement disclosure statement that includes the main features of the proposed agreement and a cost quotation of the credit, which is binding on the provider for five days before a credit agreement is concluded. When the agreement is a small credit agreement, the provider must give the consumer a pre-agreement statement and a quotation on the prescribed form. When the agreement is a large or intermediate agreement, the provider must give the consumer a pre-agreement statement in the form of the proposed agreement or in another form, addressing the matters prescribed by the Act and a quotation in the prescribed form (i.e. principal debt, interest rate and other credit costs, total cost of the credit etc).

The Act prescribes the form for small agreements. Intermediate and large agreements must be in the prescribed form, if any, or if there is no form, must contain any prescribed requirements.

Chapter 5 also deals with the maximum rate of interest, fees and charges that may be charged on credit agreements (see sections 100–106). The maximum amounts for the fees and interest rates are set out in the Regulations issued in terms of the National Credit Act (see discussion below). The Act is prescriptive as to the fees or charges that may be charged to a consumer by a credit provider. In terms of the Act, a credit agreement must not require payment by the consumer of any money or other consideration except the principal debt, an initiation fee, service fees, interest, the cost of credit insurance, default administration charges and collection costs.

Chapter 6: Collection, repayment, surrender and debt enforcement

Chapter 6 deals with the provisions relating to a consumer's right to settle the credit agreement any time before its completion date, and to make early payments under a credit agreement.

There is also provision for a process by which a consumer under an installment agreement, secured loan (e.g. notarial bond) or a lease may surrender the movable goods to the credit provider.

This chapter also sets out the procedures that a credit provider needs to follow when collecting the debt from a defaulting consumer. The Act lays down the procedure to follow before legal action may be instituted in a court of law. For instance, section 129 of the Act *inter alia* provides that a letter of demand sent to a defaulting debtor must draw the debtor's attention to the fact that he has a right to various alternative dispute resolution mechanisms, before the credit provider may institute legal proceedings.

Chapter 7: Dispute settlement other than debt enforcement

Chapter 7 promotes the use of Ombuds and other alternative dispute agencies. Parties are encouraged to resolve disputes through mediation, conciliation or arbitration through provincial consumer courts, Ombuds or other such agencies before resorting to courts.

Chapter 7 also deals with the procedures for initiating complaints or making applications to the National Credit Regulator and the National Consumer Tribunal. It also sets out the orders that the Tribunal may make.

Chapter 8 and 9: Enforcement of Act and other general provisions

Chapter 8 deals with enforcing the Act. The Act makes provision for the issuance of search warrants so that the premises of credit providers may be searched. The Act also circumscribes the entry and search procedures.

This part of the Act also stipulates the offences that could be committed under the Act and provides for the maximum penalties payable. However, the Act also specifically confers on a Magistrates' Court the jurisdiction to impose any penalties, notwithstanding anything to the contrary contained in any other law.

The remainder of Chapter 8 deals with other miscellaneous matters.

Chapter 9 contains the section authorising the Minister to issue regulations. It also contains the section repealing the Usury Act and the Credit Agreements Act.

Schedule 3 of the Act

Schedule 3 of the Act contains various transitional provisions, such as that, subject to certain reservations, the Act applies to credit agreements made before the effective date of the Act (i.e. 1 June 2006), if those agreements would have fallen within the application of the Act if it had been in effect when the agreement was made. Despite the repeal of the Usury Act, the maximum annual finance charge set in terms thereof continues to be in force until the Minister prescribes a maximum rate of interest in terms of the Act (this will remain in force until 31 May 2007, whereafter the relevant sections of the National Credit Act and their accompanying regulations will come into operation, on 1 June 2007).

1.2. Operational date of the National Credit Act

The National Credit Act was published and assented to during March 2006 (see *Government Gazette* 28619 of 15 March 2006). However, the Act will come into effect in three phases (see *Government Gazette* 28824 of 11 May 2006 Proc 22):

- A large part of the Act came into operation on 1 June 2006, including the sections that dealt with⁴³: the definitions; application of the Act; categories and classification of credit agreements; the establishment of the National Credit Regulator; establishment of a National Credit Register; the registration requirements of credit providers, debt counsellors and credit bureaux; and the registration procedures.
- On 1 September 2006 the National Consumer Tribunal was established and all its enabling sections came into operation. Certain sections dealing with the credit information held by credit bureaux and consumers' rights to challenge such information also came into operation on this date.⁴⁴
- The remaining sections of the Act will come into operation on 1 June 2007.⁴⁵ These include the sections dealing with consumer rights; credit marketing practices; over-indebtedness and reckless lending; consumer credit agreements (e.g. the pre-agreement disclosure, the form of the agreement, alteration of agreements, rescission and termination of agreements); the allowed interest rates, costs of credit and other charges and fees; collection and repayment of credit agreements; the debt collecting procedures and alternative dispute settlement procedures; and the agents of credit providers.

2. Main components of the National Credit Regulations 2006

The National Credit Act must be read with the Regulations promulgated in terms thereof (published in Government *Gazette* 28864 of 31 May 2006, Regulation *Gazette* No 8477, R489). The Regulations are complementary to their enabling sections contained in the National Credit Act. They provide for matters not specifically dealt with by the sections of the Act. For instance they further regulate the manner in which credit providers provide credit.

The National Credit Regulations consist of 76 regulations grouped under ten chapters:

- Chapter 1: Interpretation and Application of Act;
- Chapter 2: Registration requirements, criteria and procedures;
- Chapter 3: Consumer Credit Policy;
- Chapter 4: Consumer Credit Agreements;

⁴³ For full details see sections 1–25; 35–59; 69; 73; 134–162; 164–173; and schedules 1–3.

⁴⁴ For full details see sections 26–34; 67–68; 70; and 72.

⁴⁵ For full details see sections 60–66; 71; 74–133; and 163.

- Chapter 5: Interest and Fees;
- Chapter 6: Dispute Resolution;
- Chapter 7: Record-keeping and Registers;
- Chapter 8: Compliance and Reporting;
- Chapter 9: Transitional Provisions; and
- Chapter 10: Prescribed Forms.

There are also two schedules. The first contains the prescribed forms referred to in the Regulations, while the second sets out the prescribed fees payable for certain services, for example a fee charged by a credit bureau for a credit record may not exceed R20.

The discussion below focuses on the main components of each chapter of the National Credit Regulations. It is not intended to be a comprehensive discussion of all the regulations or a detailed discussion of their application.

Chapter 1: Interpretation and application of Act

Chapter 1 of the Regulations (see regulations 1–3) *inter alia* defines words and terms used in the Regulations; and authorises the Regulator to grant extensions where specific periods are prescribed.

Chapter 2: Registration requirements, criteria and procedures

Chapter 2 (see sections 4–9) prescribes the forms that a credit provider, debt counsellor or credit bureau must submit when applying to register with the Regulator. It also details procedures a registrant may use when requesting the Regulator to review his conditions of registration or cancelling his registration. A certificate of registration must comply with certain requirements, and these are also set out.

Regulation 10 sets out the requirements (i.e. education and experience) for a debt counsellor to be able register with the Regulator.

The rest of the regulations deal with the enforcement of the National Credit Act. For instance, it makes provision for and prescribes the forms to be used when the Regulator issues compliance notices and other notices to unregistered persons to register before continuing with their business activities. It also determines the amount of administrative fines payable for contravention of the Act. Provision is also made for the prescribed certificate that the CEO of the Regulator needs to issue when appointing inspectors or investigators.

Chapter 3: Consumer Credit Policy

The first part of Chapter 3 deals with the maximum retention periods that a consumer's credit information (e.g. civil court judgments, sequestration etc) may be displayed by credit bureaux. Credit bureaux must also comply with the prescribed standards when maintaining a consumer's credit information. The procedure for submitting a consumer's credit information is also prescribed in the Regulations. The procedure to follow when a consumer requests his credit report is also set out (see regulations 17–20).

Regulation 21 and 22 stipulate the exact information that a credit provider needs to display in certain advertisements when offering to supply credit (e.g. when an advertisement is placed for a specific credit product). Provision is also made for the exact form the required information needs to be in.

There is also a regulation that assists with the exclusion of certain credit loans (e.g. student or school loans) from the ambit of the reckless lending provisions set out in the Act (see regulation 23). Regulations 24–27 are complementary to the sections of the Act dealing with over-indebtedness and debt counselling. These regulations prescribe the exact information that a consumer must provide to a debt counsellor when application for a debt review is made. The procedure that a debt counsellor must follow when he reviews the debt of a consumer is also set out in the Regulations.

Chapter 4: Consumer credit agreements

Chapter 4 deals with credit agreements, for example the exact disclosure required before an agreement may be concluded, the form in which the agreement must be, specific information that needs to be included in the agreement, and the cancellation, rescission or alteration of a credit agreement.

Regulations 28–31 are complementary to sections 92 and 93 of the Act (see discussion above) dealing with pre-agreement disclosures and the form of agreements. The Regulations prescribe the forms that must be used together with all the requirements that need to be met when pre-agreement statements and quotations for small, medium or large agreements are supplied to consumers.

Regulation 35 also prescribes the exact form and the required information that needs to be included in the statement of account for a small agreement.

Chapter 5: Interest and Fees

Chapter 5 (see regulations 39–48) is complementary to sections 100–106 of the Act (see Chapter 5 Part C) that specifically provide for the allowable costs of credit (interest, fees and other charges) that may be charged on credit agreements. The Regulations set out the maximum amounts for the fees (e.g. service fees, initiation fee, etc) and interest rates that may be charged by credit providers. For instance, in terms of the Regulations the maximum “interest rate” which can be charged for a credit agreement is calculated according to a formula where RR is the reference rate, being the ruling South African Reserve Bank Repurchase Rate, as at the time that the credit agreement is entered into. There are also seven different types of credit (e.g. mortgage agreements, credit facilities, development credit agreements etc) to which different maximum interest rates and initiation fees apply.

Chapter 6: Dispute Resolution

Chapter 6 of the Regulations complement Chapter 7 of the National Credit Act. It deals with the process an alternative dispute resolution agent must follow if the alternative dispute resolution failed. It also deals with the procedures and the prescribed forms that need to be completed and submitted when initiating complaints or making applications to the National Credit Regulator and the National Consumer Tribunal.

Chapter 7: Record-keeping and Registers

Regulations 55–61 prescribe all the records and registers that a registrant (credit provider, debt counsellor and credit bureau) needs to keep, the format in which they should be kept, and the time period of safe-keeping. Regulation 57 sets out the necessary information (e.g. all credit providers registered) that the Regulator needs to include in his National Register of Registration.

Chapter 8: Compliance and Reporting

Regulations 62–72 set out all the required reports (set out in prescribed forms) and documents that a registrant (credit provider, debt counsellor and credit bureau) need to submit to the Regulator on the various prescribed dates.

Chapter 9 and 10; Transitional Provisions and Prescribed Forms

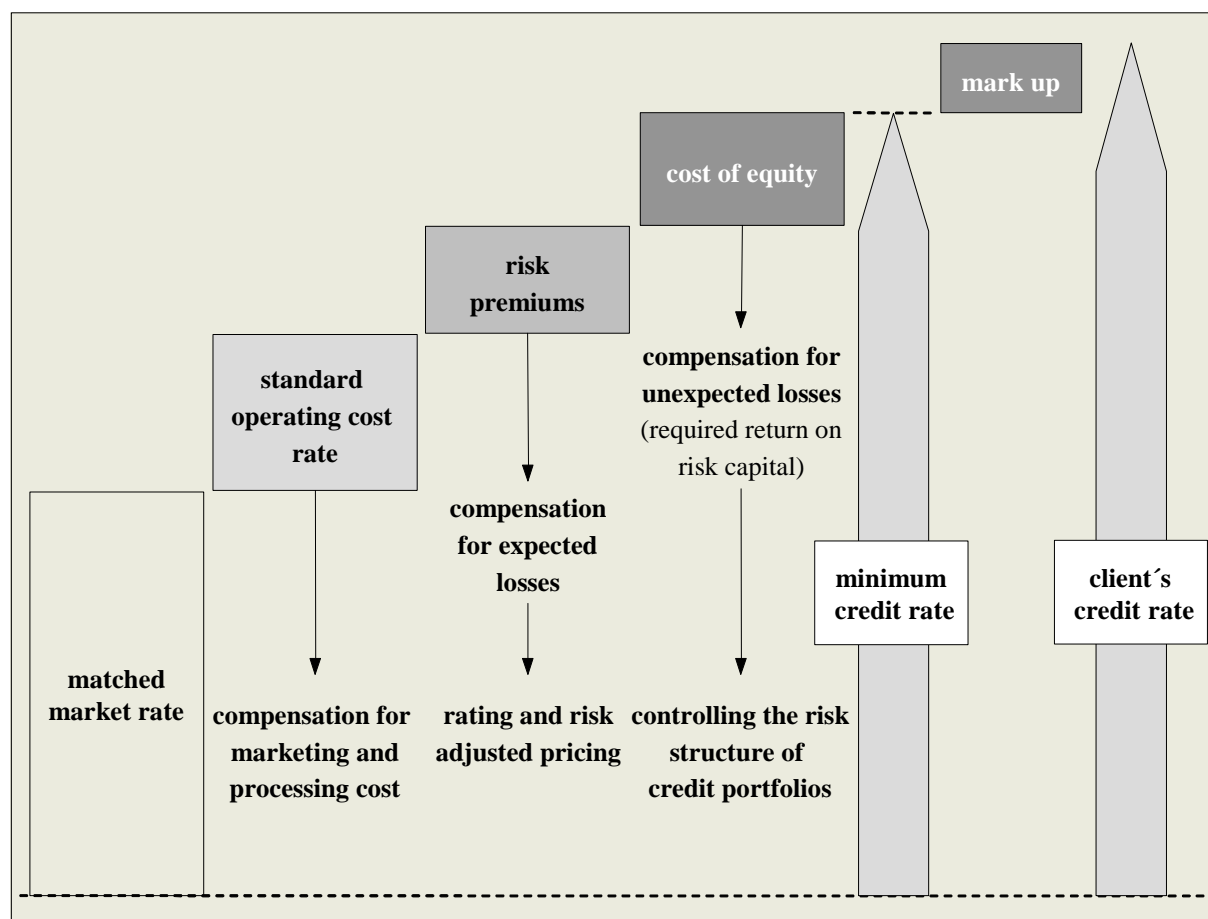
Chapter 9 contains the transitional provisions of the Regulations.

Lastly, Chapter 10 stipulates that all the prescribed forms are contained in schedule 1 to the Regulations. It also states how the prescribed forms should be used and allows for the electronic submission of these forms.

APPENDIX 2: THEORETICAL ANALYSIS OF THE CREDIT PRICE COMPONENTS – BY PROF H SCHIERENBECK

The credit rate charged by a bank can be separated into five main components (see Figure 1).

Appendix 2 – Figure 1: Credit rate calculation

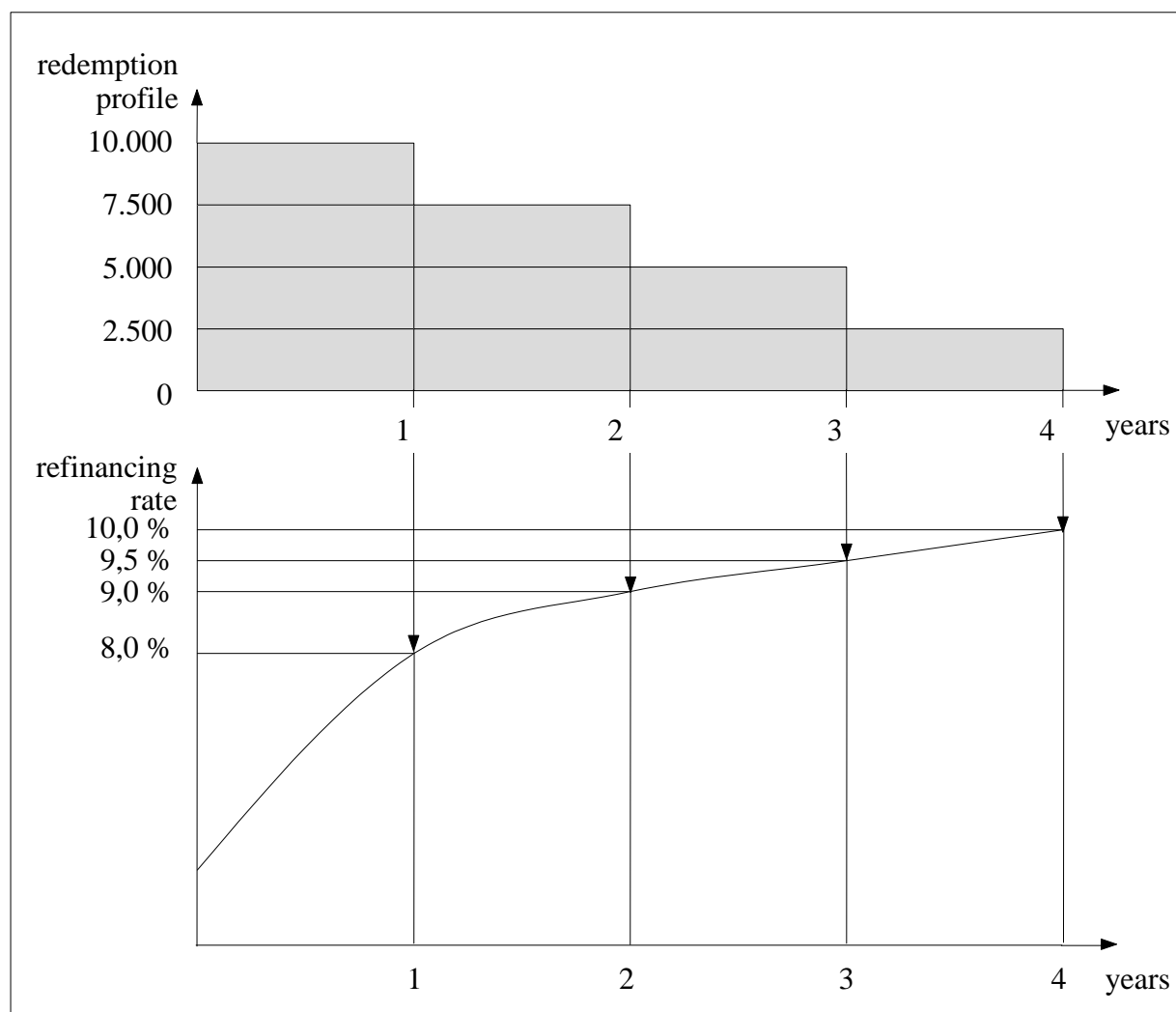


1.1. The matched market rate

The first component of the credit rate is the **credit funds (refinance) rate**. It should be calculated by using the prevailing market rates at the time of the cash outlay and by mirroring the capital base and/or cash flow of the customer credit by means of capital and money-market refinance contracts. This means calculating a market-related cost of funds that has the same maturity profile as the underlying customer credit (i.e. the **Matched Funds Transfer Pricing Concept**).

Figure 2 clarifies this concept with an example based on a four-year consumer credit of R10,000 with annual redemption payments of R2,500 (excluding interest payments). The market refinancing rates are 10% for four years' money, 9,5% for three years, 9,0% for two years, and 8% for one year's money (i.e. a normal slope of market yield curve).

Appendix 2 – Figure 2: Capital lockup



Thus R2,500 has to be refinanced for four years at a market interest rate of 10%. Another R2,500 has to be refinanced for three years at an interest rate of 9,5% and so on. The matched market rate (i_{MMR}) can accordingly be calculated either approximately as time weighted average of the refinancing rates: i.e.

$$i_{MMR} = \frac{(4 * 10\%) + (3 * 9,5\%) + (2 * 9,0\%) + (1 * 8,0\%)}{10} = 9,45\%$$

or exactly as the effective yield by means of the following equation which can be solved by using a calculation program:

$$\frac{2500 * (8,0 \% + 9,0 \% + 9,5 \% + 10,0 \%) + 2500}{(1 + i_{MMR})} + \frac{2500 * (9,0 \% + 9,5 \% + 10,0 \%) + 2500}{(1 + i_{MMR})^2} + \frac{2500 * (9,5 \% + 10,0 \%) + 2500}{(1 + i_{MMR})^3} + \frac{2500 * 10,0 \% + 2500}{(1 + i_{MMR})^4} = 10\ 000$$

$$i_{MMR} = 9,42 \%$$

1.2. The standard operation or origination costs

As a second component of the minimum credit rate, the **standard operating or origination costs** have to be included. Standard costs are costs calculated on the basis of a specific targeted minimum productivity of input factors (like processing time and labour units) combined with a specific price quotation per input factor.

Table 1 shows, as an example, how these operating costs are being calculated for a micro loan. The cost per time unit (one minute) is based upon an assumed annual salary of R75,000 and an annual work time of 1 800 hours.

Appendix 2 – Table 1: Example for standard operating costs			
Process	Cost per unit (in R)	Processing units	Standard operating costs (in R)
Initiation costs			
• Client counselling	0,7	15	11
• Assisting the client when completing the credit application	0,7	10	7
• Checking and deciding upon the credit request	0,7	10	7
• Data logging	0,7	6	4
• Credit Payment	0,7	6	4
Total initiation costs			33
Closing costs			
• Closing and filing costs	0,7	10	7
Total closing costs			7
Total contract related operating costs			40
Annual administration costs			
• Regular monitoring	0,7	10	7
• Calculated infrastructure costs (IT, buildings, etc.)	50	1	50
Calculated marketing expenditures	25	1	25
• Costs for credit statement	100	1	100
Total annual administration costs			182

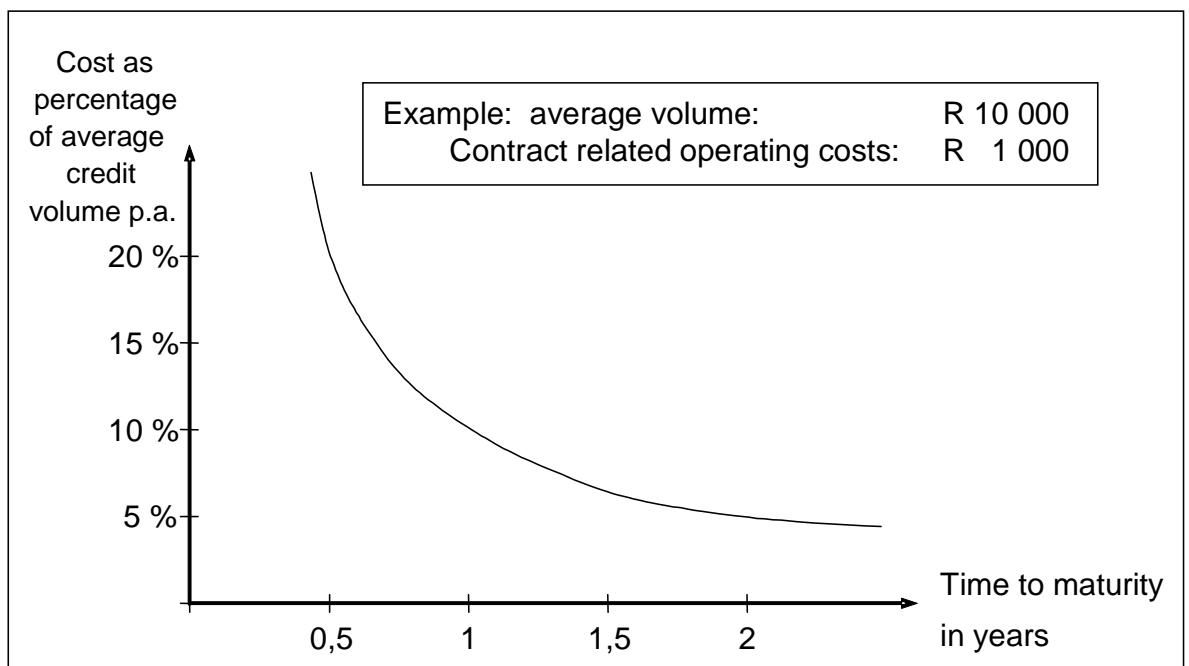
While the contract-related costs, which can be separated into initiation and closing costs, have to be divided by the time to maturity and the amount of the credit, the total administration costs that emerge annually only have to be divided by the credit amount to calculate the operating cost rate to be included as part of the minimum credit rate.

The calculation of the contract-related operating costs is therefore:

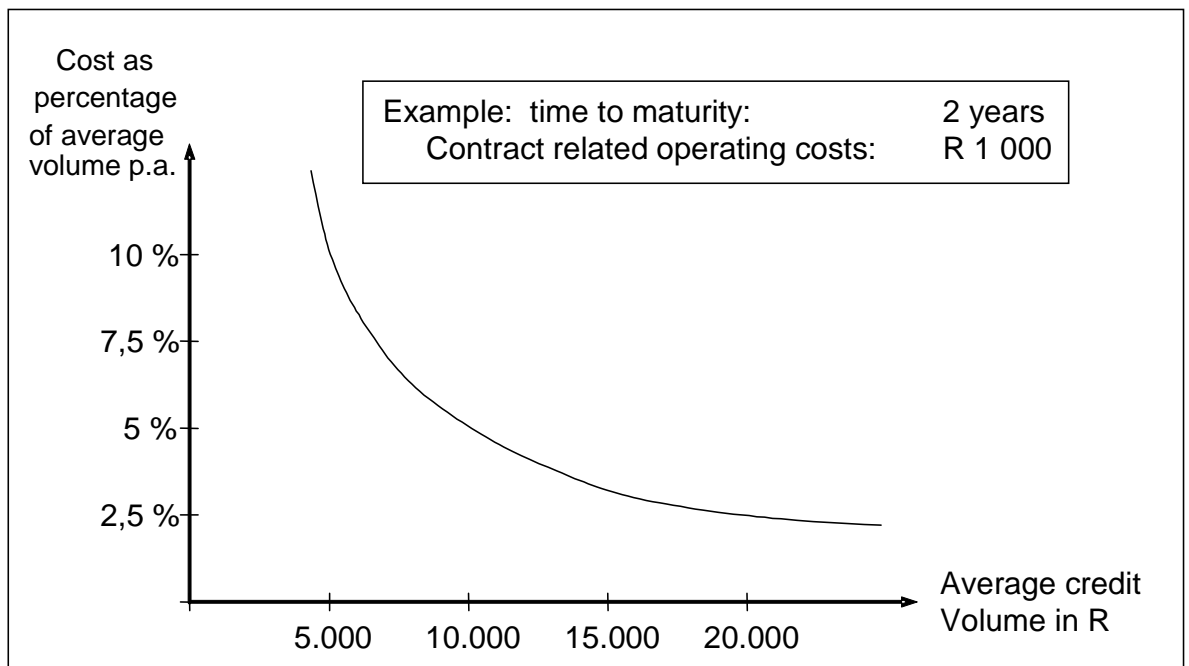
$$\text{Cost as percentage of credit volume p.a.} = \frac{\text{contract related operating costs}}{\text{average volume} \cdot \text{time to maturity}}$$

This can be graphically illustrated, either with given average volume or given time to maturity, as in Figures 3 and 4:

Appendix 2 – Figure 3: Cost as percentage of average credit volume p.a. with given average volume



Appendix 2 – Figure 4: Cost as percentage of average credit volume p.a. with given time to maturity



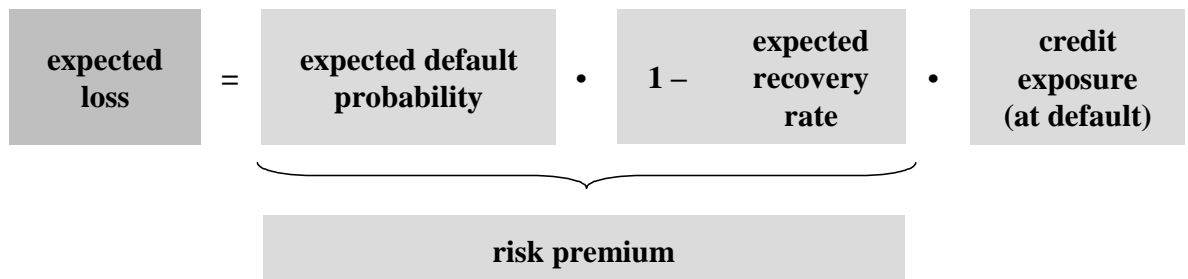
For annual administration costs the convex interrelation between costs as percentage of average credit volume per annum and the time to maturity disappears and is replaced by a constant. But the relationship between credit volume and cost as percentage of average credit volume is practically the same as for contract-related operating costs.

In many ways these functionalities are the main reason for the high costs (expressed as a percentage) of consumer credit with low credit volume and short time to maturity.

1.3. The risk premium

An important element of the minimum credit rate is the **risk premium**. Statistically, expected credit losses should not be lumped together with “real” loss surprises. They should rather be seen as part of the minimum credit rate, and can be calculated by multiplying the expected default probability by one minus the expected recovery rate (which is also mentioned as loss given default (LGD)) and the credit exposure (at default).

Whereas the default probability can be estimated by an appropriate customer rating, the expected recovery rate is primarily driven by the type of collateral and the effectiveness of workouts and recovery measures.



As part of the expected loss calculation the risk premium quantifies the expected loss per unit of credit exposure.

1.4. The unexpected loss

Besides the standard risk costs, a second component of risk-related costs has to be observed. These costs are connected to with the **unexpected losses** (the losses which exceed the expected loss). These losses have to be absorbed by equity reservations.

The regulatory requirements of Basel II that seek to cover these unexpected losses should be used to quantify the necessary equity reservations. They depend on the probability of default (PD) and the Loss Given Default (LGD), and are set by the Rules for Retail Exposures, which are given for those banks that will adopt the Internal Ratings-Based Approach (IRB).⁴⁶¹

The **cost of equity** of each credit finally results by multiplying the calculated capital requirement of the credit by the average cost of equity that corresponds to the required rate of return for equity that is usually calculated with the Capital Asset Pricing Model

¹ See Basel Committee on Banking Supervision (2004), p. 70.

The capital requirement is set as:

$$K = \text{LGD} \cdot N \left[(1-R)^{-0.5} \cdot G(\text{PD}) + \left(\frac{R}{1-R} \right)^{0.5} \cdot G(0,999) \right] - \text{PD} \cdot \text{LGD}$$

with correlation $R = 0,15$ for residential mortgage exposures, $R = 0,04$ for qualifying revolving retail exposures and $R = 0,003 \cdot \frac{1 - e^{-35 \cdot \text{PD}}}{1 - e^{-35}} + 0,16 \cdot \frac{1 - (1 - e^{-35 \cdot \text{PD}})}{1 - e^{-35}}$ for other retail exposures.

1.5. The mark-up

Finally, after calculating the minimum credit rate by adding the matched market rate, the standard operating costs, the risk premiums and the cost of equity, a bank will usually strive to earn a **mark-up** if and when the lenders have earning targets that are beyond the minimum credit rate or the cost of equity capital respectively.

APPENDIX 3: THEORETICAL ANALYSIS OF THE ADVANTAGES OF A ‘STRUCTURED’ INTEREST RATE CAP – BY PROF H SCHIERENBECK

In terms of the “structured” interest rate cap, each of the five components of the credit rate (see Figure 1 in Appendix 2) become policy variables. Applying a structured cap allows the regulator to shift the focus from a simple price control to a spread-, respective margin-control.

The implementation of this approach requires a number of steps. In the first place it is advisable to separate the four spread components (namely operating costs; risk premiums; equity capital costs; and mark-up) from the refinancing component (or the Matched Market Rate that is typically quoted in the professional money markets). Secondly, the four spread components have to be carefully quantified for local conditions; i.e. they should reflect the special features of the South African consumer credit market. Thirdly, where the Matched Market Rate may fluctuate on a daily basis, the maximum values of the spread components (or the usury margin) should remain relatively stable over time.

1.1. Operation costs

Operating costs (administering, consulting, processing and selling costs) are “transaction driven” and usually independent of the credit volume. Thus small loans with a short maturity bear a high cost burden in relation to their volume.

Proposal: There should be a fixed fee upfront to prevent the cap reaching exorbitant figures for small loans with a short maturity. The key is externalising the cost of origination and servicing from the interest, i.e. removing the “natural bias” against small transactions and transactions of short duration.

The fixed fee upfront should be capped by a “standard ceiling” approach, which is oriented toward a predetermined benchmark. There would then be an incentive for lenders to reach this benchmark to recuperate the origination cost by means of the standard fee on profitability.

A possible approach would be to determine the standard operating costs as shown in Table 1 (Appendix 2). To reduce the complexity of the system only notable differences between the processes of different products should be observed. For example, a mortgage should have higher origination costs than a micro-loan because the valuation of the security will require more time. **Maybe** it is feasible only to distinguish between initiation costs (excluding security-valuation expenses), the costs to value the securities and administration costs per year.

Such a distinction could lead to an origination cost matrix (see Table 1) In this example, based on the “Rules for Retail Exposure” of Basel II, three types of credit (mortgages, revolving retail credits and other retail credits) are distinguished.

Appendix 3: Table 1: Origination costs (in Rand)			
Type of credit	Initiation costs	Valuation costs	Administration costs p.a.
Mortgages	500	500	250
Revolving retail credits	50	0	200
Other retail credits	150	0	200

1.2. Risk premiums

Risk premiums are determined by the expected default probability of the credit and the recovery rate. If Credit Life Insurance is calculated in an appropriate way (i.e. NOT being a *de facto* “mark-up” component!), it should be identical with this risk premium.

Proposal: The credit interest rate cap should be fixed, dependant on the

- Prevailing probabilities of default (calculated per client segment or as an average over all segments) and
- Expected recovery rates as an historical average.

The expected default probability and the expected recovery rate should again be based on a relatively simple calculation, but nonetheless be sufficiently accurate. The relevant factors should be easily observable and not only be detectable by sophisticated credit screening used by banks and other lenders to measure the credit risk.

The Living Standards Measure, which is a proxy for income levels, could be used to overcome the problem of segmenting retail clients according to their underlying risk characteristics. Even though the usefulness of LSM has to be discussed in future studies, it will be used in the following example because the interest rate distinctions that are observed between clients of different LSM classes are probably to a great extent driven by different default probabilities (see Table 2).

Appendix 3 – Table 2: Default probabilities		
(Figures are only of exemplary kind)		
LSM-class	Income per month R	PD
10	21.591	0,50 %
9	10.561	1,00 %
8	7.427	3,00 %
7	5.504	6,00 %
6	3.575	10,00 %
5	2.195	14,00 %
4	1.534	16,00 %
3	1.104	19,00 %
2	879	22,00 %
1	770	24,00 %

The recovery rates could be determined by an analysis based on empirical data and by the type of credit. Because of the underlying security this would mean a higher recovery rate for mortgages than for microloans or credit card accounts, as shown in Table 3.

Appendix 3 – Table 3 Recovery rates	
Type of credit	Recovery rates
Mortgages	60 %
Revolving retail credits	30 %
Other retail credits	40 %

Given the default probabilities and the recovery rates, the risk premium can be diagrammed in a schedule comparable to Table 4. For example, if the probability of

default for a LSM6 client is 10% (see Table 2), while the recovery rate for “Other retail credits” is 40% (see Table 3), the risk premium in this specific case is (see Table 4): $10\% * (1 - 40\%) = 6,00\%$.

Appendix 3 – Table 4: Risk premium			
Type of credit \ LSM	Mortgages	Revolving retail credits	Other retail credits
10	0,20 %	0,35 %	0,30 %
9	0,40 %	0,70 %	0,60 %
8	1,20 %	2,10 %	1,80 %
7	2,40 %	4,20 %	3,60 %
6	4,00 %	7,00 %	6,00 %
5	5,60 %	9,80 %	8,40 %
4	6,40 %	11,20 %	9,60 %
3	7,60 %	13,30 %	11,40 %
2	8,80 %	15,40 %	13,20 %
1	9,60 %	16,80 %	14,40 %

1.3. Equity capital costs

Equity capital costs are also part of the structured cap. They are calculated by multiplying the average cost of equity of South African banks with the capital requirements.

Proposal: To include equity capital cost it is advised to calculate the capital requirement according to the regulatory requirements that the Basel II accord adopts for retail credit exposures in the Internal Ratings-Based Approach and multiply them with the empirical cost rates of equity.

The capital requirement (K) in Table 5 is calculated by using the default probabilities and the recovery rates of Tables 2 and 3 and formulas. For example, using again a LSM6 bank client, the correlation for other retail credits, R, would be calculated as follows:

$$R = 0,03 \cdot \frac{1 - e^{-35 \cdot 0,1}}{1 - e^{-35}} + 0,16 \cdot \frac{1 - (1 - e^{-35 \cdot 0,1})}{1 - e^{-35}}$$

$$R = 0.0339$$

while the capital requirement, K, would be determined as follows:

$$K = 0.6 \cdot N \left[(1 - 0.339)^{-0.5} \cdot G(0.1) + \left(\frac{0.0339}{1 - 0.339} \right)^{0.5} \cdot G(0.999) \right] - 0.1 \cdot 0.6$$

$$K = 8,06\% \text{ p.a.}$$

Appendix 3 – Table 5: Capital requirement (K)			
Type of credit \ LSM	Mortgages	Revolving credits retail	Other retail credits
10	2,49 %	1,25 %	3,45 %
9	4,01 %	2,14 %	4,88 %
8	7,96 %	4,81 %	6,70 %
7	11,56 %	7,67 %	7,22 %
6	14,54 %	10,44 %	8,06 %
5	16,41 %	12,50 %	9,17 %
4	17,08 %	13,33 %	9,72 %
3	17,81 %	14,48 %	10,47 %
2	18,30 %	15,22 %	11,11 %
1	18,51 %	15,69 %	11,47 %

Accordingly, the equity capital costs are calculated by estimating an average cost of equity and multiplying this rate with the capital requirement of a credit according to the LSM-class and the type of credit (see Table 5). The cost of equity for banks as prescribed by the CAPM has thereby to be determined by empirical observations. Taking Swiss banks for example, the average cost of equity capital for the segment retail banking was around 8% for 2004. Taking a higher risk factor and higher risk-free returns for South African banks into account, the respective cost rate could be 10% – 15%. By taking the higher value (15%) the equity capital cost rate as a percentage of

credit volume is depicted in Table 6. For example the equity capital costs of an “other retail credit” for a LSM-class 6 bank client are determined as follows:

$$15\% * 8,06\% = 1,21\%$$

Appendix 3 – Table 6: Equity capital cost rates			
Type of credit	Mortgages	Revolving retail credits	Other retail credits
LSM			
10	0,37 %	0,19 %	0,52 %
9	0,60 %	0,32 %	0,73 %
8	1,19 %	0,72 %	1,00 %
7	1,73 %	1,15 %	1,08 %
6	2,18 %	1,57 %	1,21 %
5	2,46 %	1,87 %	1,38 %
4	2,56 %	2,00 %	1,46 %
3	2,67 %	2,16 %	1,57 %
2	2,74 %	2,28 %	1,67 %
1	2,78 %	2,35 %	1,72 %

1.4. Mark-up

A possible mark-up should be allowed. From a regulatory perspective this should be restricted to prevent usury type lending practices.

Proposal: The mark-up should be linked to a maximum multiplier of the equity capital costs. A simple way would be to allow for a mark-up that must not exceed the equity capital cost by a certain percentage (a 100% surcharge seems a reasonable maximum; a 200% surcharge is clearly excessive but perhaps useful in a bridging period). In case of a 100% mark-up the resulting figures would duplicate those shown in Table 6.

1.5. Conclusion

The structured interest rate cap consists of two components. First there is a maximum front-up fee, fixed in an absolute figure to cover the standard operating costs of a

lender. Secondly there is an upper ceiling for the allowable spread, consisting of the sum of the prevailing matched funds market rate, the standard risk premium, the equity capital costs and the allowable mark up.

The following example indicates the composition of the interest rate cap for a consumer of LSM-class 6 with a non-revolving retail credit of R1,000 and with a time to maturity of six months (without amortisation during the maturity):

- (1) The front-up fee to cover the origination costs may have an upper ceiling of R250, consisting of allowed initiation costs of R150 and administration costs of R100.
- (2) The risk premium is set at 3,00% resulting from the figure of 6% p.a. (see Table 5).
- (3) The equity capital cost rate is compounded at 0,60 % resulting in the figure of 1,21 % p.a.
- (4) The mark-up in the case of a 100% possible surcharge on the capital costs amounts to 0,60 % as well.

Accordingly, the maximum allowable spread beyond that maximum front-up fee of R250 would amount to 4,20%. Calculating them into a single percentage and adding a prevailing refinance-rate of say 10% p.a. for the loan, the APRC would be:

$$1\ 000 = \frac{1\ 000 + 250 + 1\ 000 * (5,00 \% + 3,00 \% + 0,60 \% + 0,60 \%)}{(1 + \text{APRC})^{0,5}}$$

$$\text{APRC} = 80,1 \%$$

This rate has to be published on any credit contract in the European Union and Switzerland. The disclosure requirements in the US are slightly different, but not less involved. The South African regulatory authorities are advised to use the European methodology of APRC, or a variation thereof, in their disclosure requirements as well.