MAKING FINANCIAL MARKETS WORK FOR THE POOR

ACCESS TO HOUSING FINANCE– CONSIDERING THE NEXT PHASE OF THE FSC TARGETS

March 2009

Prepared for the FinMark Trust by
Illana Melzer

Acknowledgements
As always the generous and insightful input of Kecia Rust has been invaluable in directing the research, in ensuring that interesting and critical hypotheses are explored and that the findings are readable. Any omissions or errors remain the responsibility of the author.

▲ **FINMARK TRUST** PO Box 61674 Marshalltown 2107 Republic of South Africa ▲
Ground Floor, Howick Gardens, Waterfall Park, 84 Bekker Road, Vorna Valley 1686
Tel +27 11 315 9197 ▲ Fax +27 11 645 6896 ▲ E-mail info@finmark.org.za

TABLE OF CONTENTS

1 INTRODUCTION

This paper is the fourth in a series charting the access frontier for housing finance in South Africa. It traces an exceptional journey over an exceptional time period. The journey begins with banks grappling with the challenges of expanding market access for housing finance products. Targets stipulated as part of the Financial Sector Charter ("FSC") process coupled with the credible threat of legislated lending targets galvanised action. The banks launched new entry-level products, created affordable housing divisions and changed some credit granting practices in order to enhance access. They also became directly involved in housing supply in order to alleviate blockages that jeopardised their ability to meet FSC targets. They were aided by a favourable economic environment with interest rates at historic lows and strong growth in formal sector employment. These efforts enabled the banks to meet their origination targets. Just in time too – the last year of the target time period witnessed higher interest rates accompanying a significant change in credit regulation. More recently the global credit crisis has had a direct impact on the availability of funding.

A key question is what origination target would be realistic for the next five years. Perhaps more importantly, it is critical to reflect on what the past can teach us and what these lessons mean for the future of lending targets in the low income market.

This paper attempts to assess these issues by exploring the extent to which the banks are able to provide housing finance of various types and the capacity of the FSC target market to absorb housing finance given higher interest rates and relatively high house prices. The paper also explores the implications of this analysis for the future of the FSC targets, or, in the event the FSC is not revived, general targets that will no doubt be explored by the National Department of Housing and the Banking Association of South Africa to expand access to housing finance for lower income households. These may include sustainable market mechanisms, subsidies or a combination of both.

The scope of the analysis covers mortgages, pension-backed or fully guaranteed loans and unsecured loans. The analysis relies on various data sources, principally the annual FinScope™ survey (the focus this year is on the 2007 survey) and the 2005/2006 Income and Expenditure Survey[1] ("IES") to characterise the market and explore and quantify access constraints. While

[1] The IES was conducted by Statistics South Africa over the period September 2005 to August 2006. Findings are weighted back to April 2006. The survey sample consists of over 21,000 households country wide. The survey uses a

FinScope™ is a survey of individuals, the IES is a household survey enabling a fairly rich assessment of access at a household level, subject of course to a range of disclaimers relating to the accuracy of the underlying data provided by households. This survey provides rich (albeit sometimes inaccurate[2]) data on household expenditure patterns, income levels and sources and contains some indicators on credit and savings product usage, which with further assumptions, provide some insight into household indebtedness and wealth levels. It therefore enables an exceptionally rich analysis of affordability and capacity to absorb credit, both of which are critical constraints in the FSC target market made more binding by rising house prices, increasing interest rates and new credit legislation in the form of the National Credit Act ("NCA"). These changes, more than changes in the income and expenditure profile of households over the period since the data was collected, are likely to be the primary forces behind market shifts. Other data sources include the General Household Survey ("GHS") from various years as well as the 2001 Census and the 2007 Community Survey.

Of course the analysis is only as robust as the underlying data and assumptions. Limitations in this regard can be overcome with additional data, much of which exists within the individual lending institutions and which, no doubt has been carefully scrutinised by these institutions as they evaluate the past five years and ponder the implications for the future.

---

diary to track household expenditure and gathers data on income from a range of sources. The survey also gathers data on outstanding loan balances by loan category, including mortgages and documents usage of some savings products, most notably pension and provident funds

[2] Stats SA notes that while salaries and wages are accurately reported by the survey, high frequency expenditure items are often under-reported. In addition items such as alcohol and tobacco tend to be significantly under-reported.

2 AN OVERVIEW OF THE FSC TARGET MARKET

The FSC target market is defined as households with an income of between R1,500 and R7,500 in 2004 Rands. The income parameters defining this market are adjusted upwards each year by CPIx as summarised below.

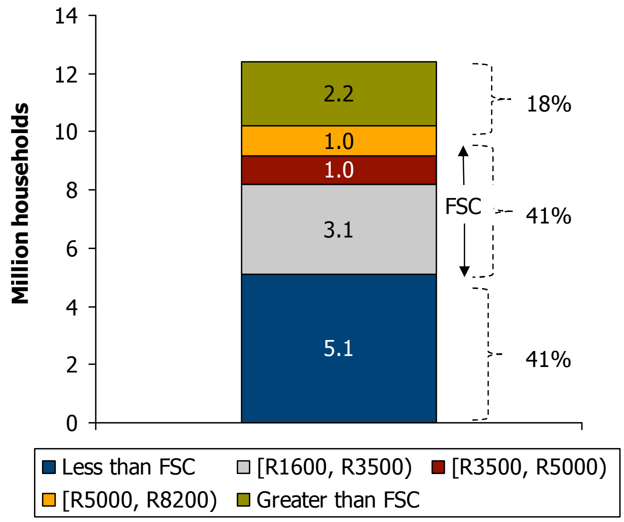
Table 1. Income parameters for the FSC target market[3]

	2004	2005	2006	2007
Lower limit	R1,500	R1,600	R1,600	R1,700
Upper limit	R7,500	R7,900	R8,200	R8,600

According to the IES there were 5.18 million households in the FSC target market defined using the FSC income bands applicable at the time of the survey (R1,600 to R8,200 per month) comprising 41% of all households in South Africa. It is noteworthy that a further 41% of households have an income of below the market threshold. Their housing needs are intended to be addressed using the subsidy mechanism (which also targets the lower bands of FSC target market households – those households earning up to R3,500 per month).

[3] Numbers have been rounded to the nearest R100

Chart 1. Household income distribution: 2006[4]



Source: IES 2005/2006

According to the IES the housing need in the target market is significant. Almost 800,000 households (15% of the market) live in shacks. While the vast majority live in formal housing (3.4 million households live in houses, townhouses or flats) 35% of these dwellings appear to be over-crowded. Many formal structures lack access to basic sanitation - 30% do not have access to a flush toilet, the bulk of these in rural areas.

Housing tenure is also a key dimension to consider. Although they may not have legally enforceable tenure, those who regard themselves as owners are more likely to invest in developing their housing assets. If the dwelling is formally owned and meets lender criteria the property may be mortgageable. According to the IES almost 70% of households in the FSC target market say they own their dwellings with 22% renting and 8% occupying their dwellings rent free. Of those who live in formal dwellings and regard themselves as owners (around 2.6 million households), just over 30% live in rural areas. While there is no survey data available on whether or not they have title, it is likely they have permission to occupy but do not own the land, making the property un-mortgageable.

[4] It is worth highlighting that while income data is often poorly captured by surveys, it is primarily at the extremes of the income distribution where the bias is most pronounced. Data on salaries and wages as well as grant income appears to be accurately reported in the IES. A key drawback of the IES is that the data is over two years old. According to the 2007 Community Survey 31% of households (3.8 million) have a monthly income of between R1,600 and R6,400. A further 8% (952,000 or so) have an income of between R6,400 and R12,800. It should be noted that household income reported in that survey is based on the personal income of household members captured in fairly wide bands. It is therefore indicative at best.

3 TRACKING ACCESS TO HOUSING FINANCE IN THE FSC TARGET MARKET

Researchers note that access and usage are not synonymous. More people may have access to a product than the number of people who choose to use it. Nevertheless, growing usage is often a directly observable indicator of market development.

Porteous (2005) notes that market development over time tends to unfold in a series of phases. An initial pioneering phase during which early entrants establish the market (often at a loss) and experiment to find workable solutions is followed by a period of growth in product penetration, profitability of the initial providers and market entry by competitor firms. Increased competition together with economies of scale lead to price reductions, in turn broadening the market and fuelling further growth. This growth phase is followed by maturity and consolidation as the market reaches its natural limit, the point at which those who wish to use the product are able to do so and non-usage reflects the unconstrained choice of consumers.

> Access problems in credit markets may arise because there are too few rather than too many access barriers in place.

This description of market development is of course a simplified one with some notable limitations with respect to housing finance. In the case of mortgages market development is obviously linked directly to the housing market – bottlenecks in housing supply will limit growth in the number of mortgages[5], while other secured lending too is constrained by access to underlying assets (pension or provident funds in this case). Further, as the sub-prime crisis has demonstrated, growth in usage does not necessarily indicate the sustainable development of a market. Market development (in the true sense) may even be accompanied by contraction as irrational and unsustainable lending is reigned in[6]. Finally while supply-side innovation may enhance access these may be countered by external developments impacting on the demand side. A case in point would be the impact of rising interest rates on affordability and by implication on access.

Nevertheless the observation that market development is typically accompanied by growth in market penetration should hold true in the South African housing finance context given the low starting point and the enthusiastic but mostly prudent efforts to make the market work by product providers at least during the initial period of the FSC, starting in January 2004. That time

[5] Of course, mortgages can be used by households that already own mortgageable property

[6] See Beck, T and A de la Torre (2006) The Basic Analytics of Access to Financial Services for a discussion on the distinction between access problems and access levels

period was characterised by innovation in product design in order to enhance access aided by favourable conditions in the funding environment. In order to mitigate key risks associated with mortgage lending, fixed rate loans were introduced and collateral insurance enabled high loan to value ratios, often in excess of 100%, while borrower education for first time home owners was introduced. Product features to enhance affordability were also introduced. Some banks increased loan terms from the standard 20 years to 30 years while others introduced 'step-up' loans with indexed instalments. The flurry of innovation slowed as the interest rate cycle entered an upward phase and the National Credit Act was introduced. It was dealt a more decisive blow by the upheaval in global credit markets precipitated by the sub-prime crisis in the USA and Britain.

As already noted there is more to access than usage. Previous analyses of access to housing finance draw heavily on the Access Frontier framework developed by Porteous[7]. This framework enables a more detailed identification and quantification of access barriers, although it does not necessarily enable a diagnosis of access problems. As the sub-prime crisis has demonstrated access problems in mortgage markets may arise because there are too few rather than too many access barriers in place.

As noted in a previous analysis of access, the access frontier framework segments the market into a number of market zones corresponding to various levels of access;

Current market: This zone comprises those who currently have or use the product (who by definition have access to the product).

The market enablement zone: Those who are within reach of the market but who do not currently have the product lie in the market enablement zone. This zone can be further sub-segmented into those who actively choose not to have a product and therefore lie beyond the natural limits of the market and those who have not yet purchased the product but are candidates for doing so.

The market development zone: This zone comprises those who cannot access the product given their location or income profile and the product's current pricing structure but who with market-aligned product and process innovation efforts are likely to be able to access the product in the near-term given the likely trajectory of product innovation and / or market dynamics.

---

[7] Porteous, D (2005). The Access Frontier as an Approach and Tool in Making Markets Work for the Poor

The market redistribution zone: Those who lie beyond the reach of the product because they are too poor lie in the *market redistribution zone*. Households in this zone will require non-market interventions such as subsidies to enable them to meet their housing needs.

The framework has been used to guide the analysis of access to mortgages, pension-backed loans and unsecured housing micro-loans.

4 ACCESS TO MORTGAGES IN THE FSC TARGET MARKET

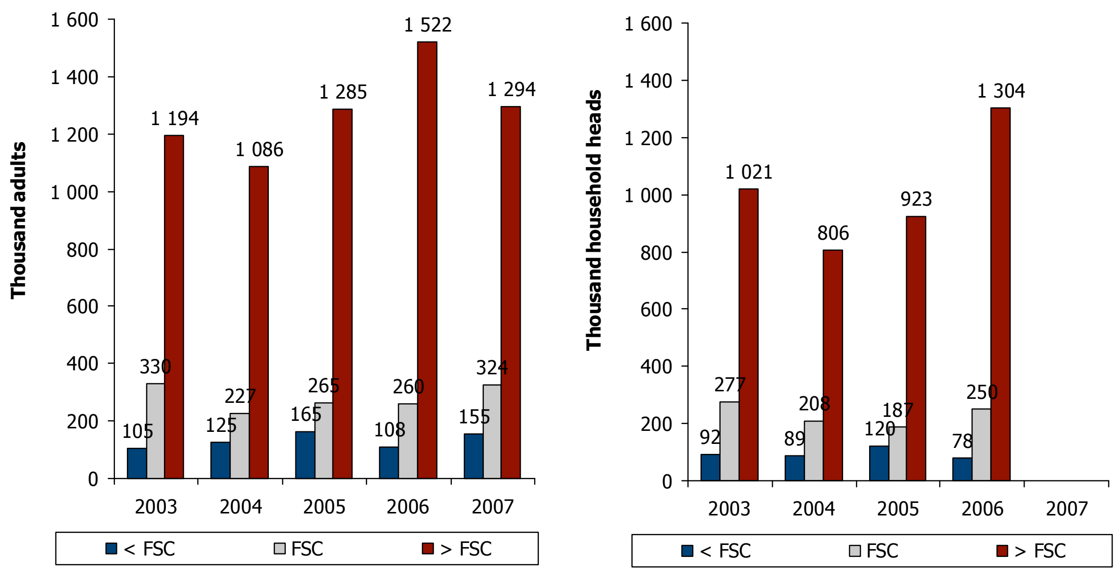
4.1 The current market: A review of demand and supply-side data

Available data does comprehensively characterise lending activity. Indicators that are available are incomplete and cannot be used to assess a number of critical hypotheses. Nevertheless it is useful to review the data that is available.

There are various indicators from FinScope on mortgage usage. The data provides a snapshot of market penetration *at a point in time* and is likely to understate FSC lending *over time*. It cannot indicate how many households who were in the FSC target market at the time they obtained a mortgage subsequently migrated out of the market as their incomes increased[8]. It also tells us nothing about when the mortgage was obtained.

The data indicates an increase in mortgage usage within the target market between 2004 and 2007 if we use adults as the unit of analysis but no clear trend over the period 2003 (the year preceding the FSC) to 2007.

Chart 2. Mortgage usage: 2003 - 2007

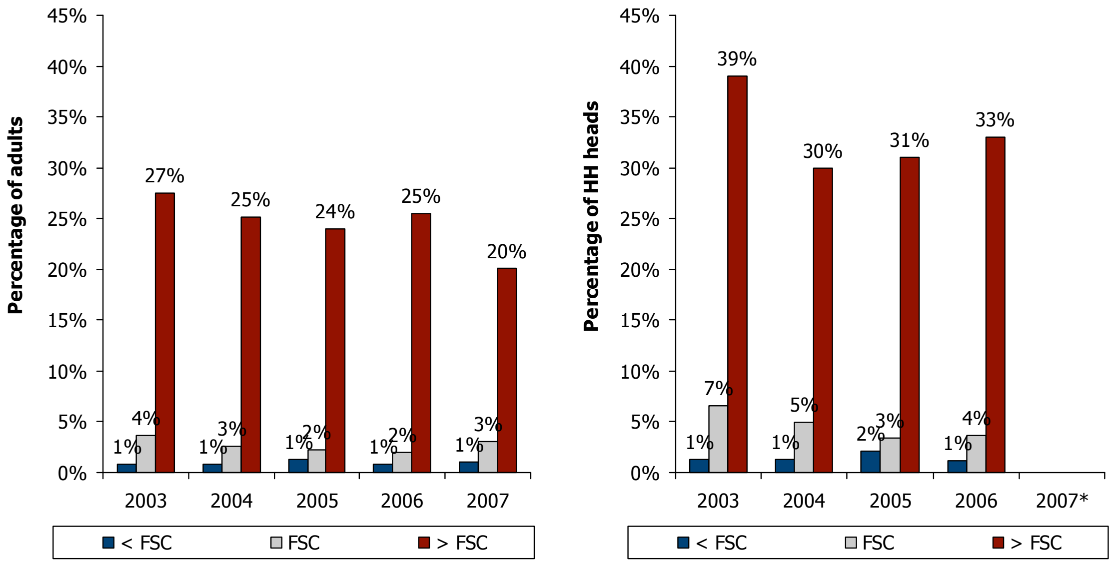


Source: FinScope 2003 to 2007
NB. Adult definition for FinScope 2003 is age 18+, for the rest it is 16+
* The FinScope 2007 questionnaire did not contain the question on household head status

[8] It also cannot identify households who were not in the FSC target market when they obtained a mortgage but now are.

While usage appears to have increased it has effectively kept pace with growth in the underlying market. Within the FSC target market there is no visible trend in penetration (as opposed to absolute levels of usage) either on a per person or per household basis using household heads where available as the unit of analysis.

Chart 3. Mortgage penetration: 2003 - 2007



Source: FinScope 2003 to 2007
NB. Adult definition for FinScope 2003 is age 18+, for the rest it is 16+
* The FinScope 2007 questionnaire did not contain the question on household head status

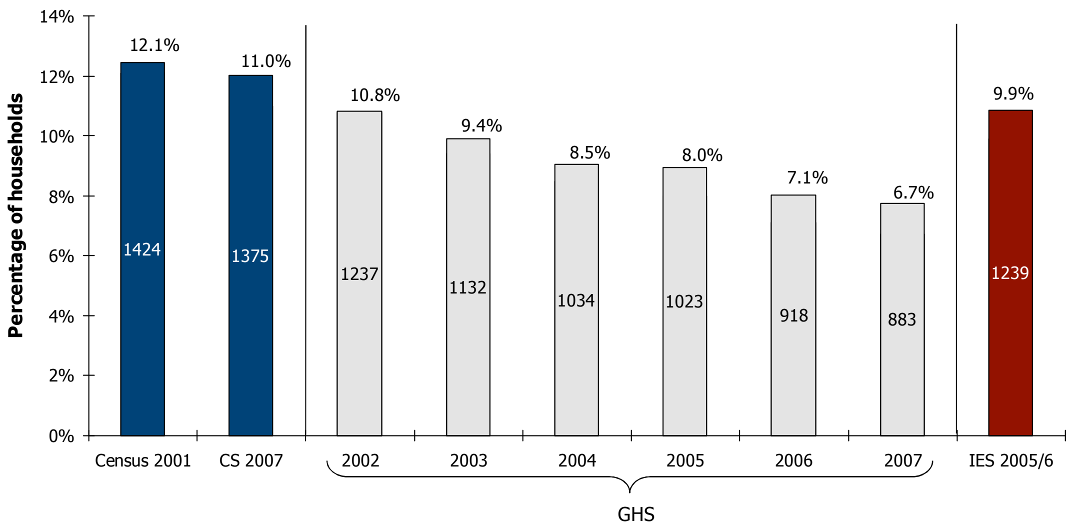
Other data is similarly inconclusive. In 2004 5% of adults in the FSC target market and 6% of those who deem themselves to be the head of the household indicated that their households made bond repayment. In 2006, the latest year for which this data is available, the percentages had declined to 2% and 3% respectively. Finally, in 2005 6% of adults reported that they had made use of a mortgage to pay for their homes. The corresponding percentage for 2007 was 4%[9].

Household survey data for the country as a whole indicates a declining market for mortgages. The trend using data from the GHS (2002 - 2007) is somewhat startling. According to that data source the number of households who appear to be paying off a mortgage declined from 1.4

[9] For those who live in formal houses the percentage of those who had used a mortgage to pay for their house was 10%. In 2007 it was 7%. Note that this data appears to be unstable. In 2006 3% of adults in the FSC target market who live in formal dwellings had used a mortgage to pay for their house

million households in 2002 to around 883,000 in 2007[10]. Over that same period the number of households in the country grew from 11.5 million to 13.3 million with the implication that penetration declined considerably. A comparison with data from the 2001 Census and 2007 Community Survey indicates that while the market has in all likelihood declined the drop off has been far less dramatic than that indicated by the GHS.

Chart 4. Owned but not fully paid off[11] 2001 – 2007 - Percentage of all households in South Africa : various sources



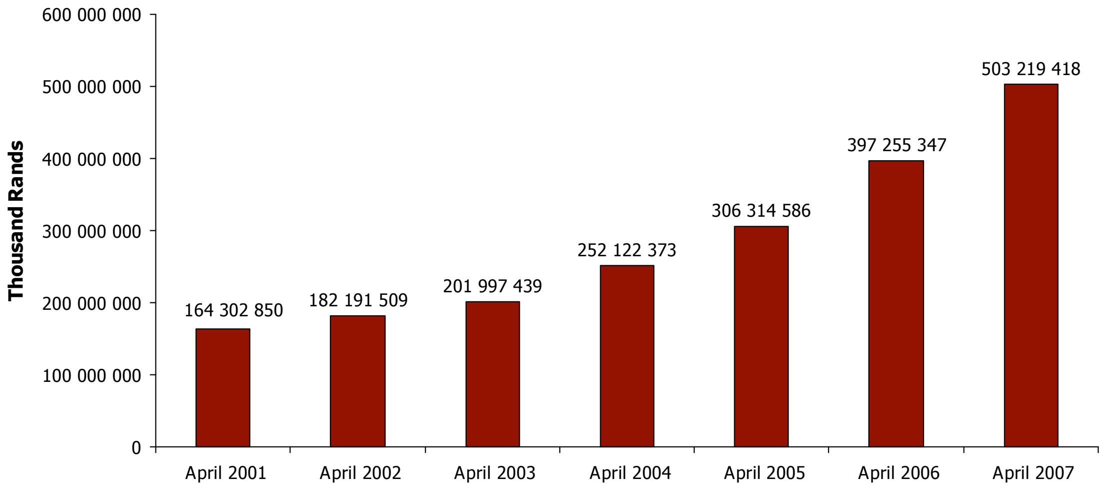
Source: Census 2001, General Household Survey 2002, 2003, 2004, 2005, 2006, 2007, Community Survey 2007, IES 2005/6

At the same time, data from the Reserve Bank indicates that the value of outstanding mortgage loans increased by more than 20% per annum over the same period. If the period of review is restricted to between 2003 and 2007, mortgage credit grew by over 25% per year.

[10] The tenure status question includes an option "Owned but not fully paid off (e.g. with a mortgage)". The data presented is restricted to those who live in houses on separate stands, flats, townhouses and units in a retirement village. It does not include those who say their homes are owned but not fully paid off if they live in rooms or flatlets, backyard dwellings or shacks

[11] Only formal dwellings are incorporated namely houses, townhouses, flats and units in retirement villages. It does not include rooms / flatlets in backyards or rooms / flatlets

Chart 5. Mortgage credit extended to households: 2001 - 2007



Source: DI 900 Returns, Reserve Bank

Supply and demand data sources are not entirely comparable - survey data focuses on main dwellings only, excluding the buy-to-let market[12] and those who mortgage other dwellings while Reserve Bank data includes credit extended to small businesses. Nevertheless, the magnitude of the discrepancy highlights other factors at play in the market. The impact of second mortgages and equity withdrawals, while not quantifiable using data disclosed by the Reserve Bank, is likely to be significant. Perhaps more obvious is the dramatic growth in house prices over the recent past. According to the ABSA House Price Index prices in the middle segment have increased by more than 20% per year between 2003 and 2007. While house price increases over the past five years may have been a reflection of a correction in a historically depressed market[13], they may well have arisen as a result of increased availability of finance. This together with severe constraints in the housing supply chain in more affordable segments of the market may well have fuelled house price inflation further[14].

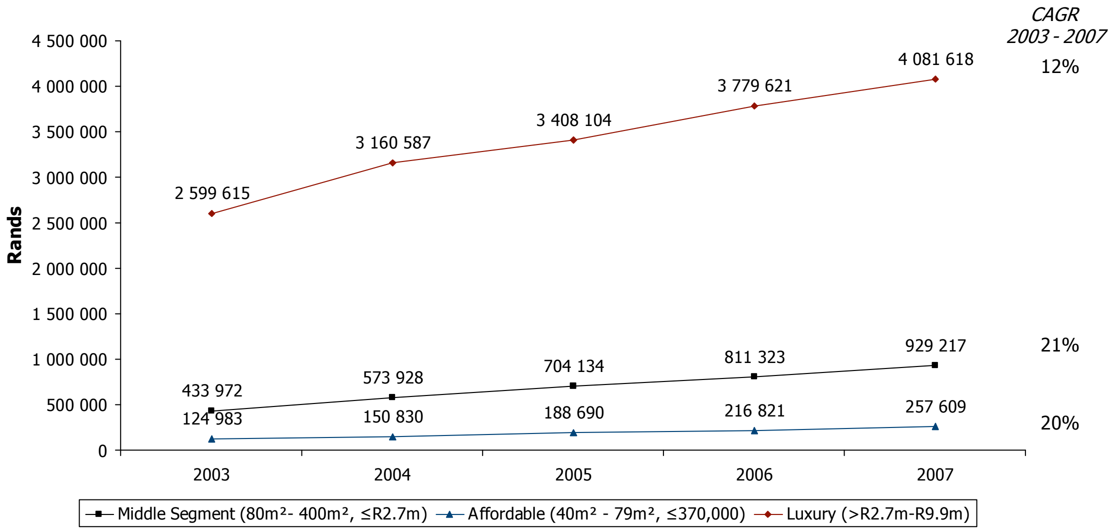
---

[12] This market has grown dramatically

[13] To quote from a recent study on household sector wealth; "Most of the rise in the early 1980s and subsequent decline in the value of housing assets relative to income is due to the rise and then decline in the real house price index. Despite an increase at an average annual rate of 8 per cent between 1999 and 2003, the real value of houses at the end of 2003 still remained about 22 per cent below the peak in 1984. The subdued real rate of return over a long period on investment in fixed property seemed to have encouraged households to concentrate their saving in risk averting institutions and financial assets rather than in riskier undertakings and fixed assets. However, from 2003 to the end of 2005, South Africa has seen exceptionally strong house price rises, alongside rising income, reductions in nominal interest rates, and buoyant consumer and business confidence." Source: Estimating household-sector wealth in South Africa by J Aron, J Muellbauer and J Prinsloo, Reserve Bank of South Africa, Quarterly Bulletin June 2006

[14] In 2005 the Banking Association commissioned a study on Housing Supply and Affordable Markets which found significant barriers in the housing supply chain

Chart 6. House prices in South Africa: The ABSA House Price Index 2003 - 2007



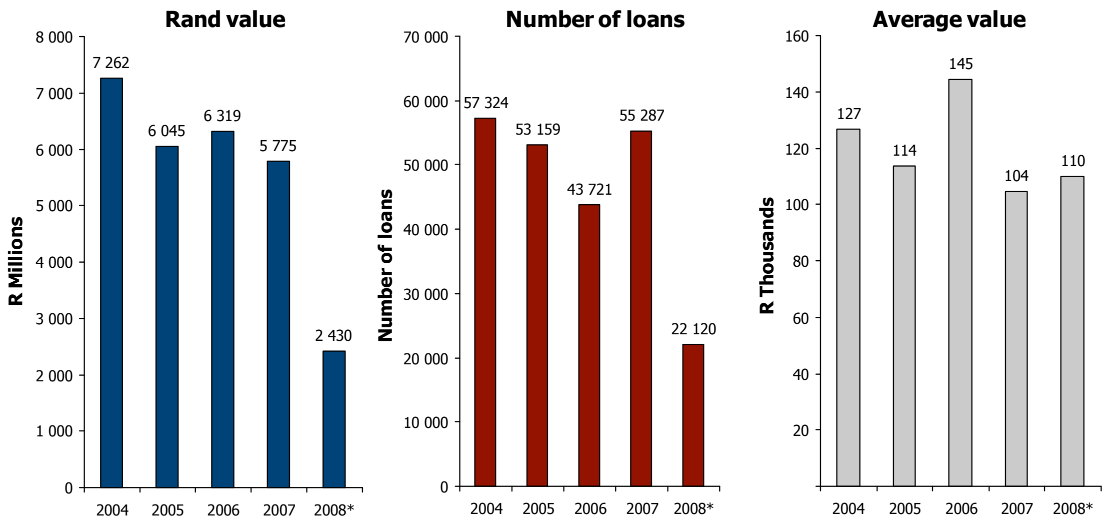
Source: ABSA

A final set of data is worth highlighting. A comparison between data from the 2000 IES and the 2005/6 IES indicates that the number and percentage of households with an outstanding mortgage balance increased over the period. However, according to that survey growth in mortgage penetration was confined to households with an income of R10,000 or more (in 2006 terms). In other segments of the market the data indicates a shrinking or at best static market. According to that survey the average value of outstanding mortgage loans increased from approximately R119,000 to R225,000 in 2006 Rand terms.

While the precise market usage and penetration estimates differ depending on the data source, they support a broad conclusion that the market for mortgage finance is not deepening, despite the best efforts of the banks to increase access.

With respect to the FSC target market, unaudited data from the Banking Association of South Africa ("BASA") from 2004 to the end of the third quarter in 2008 is summarised below:

Chart 7. Mortgage origination in the FSC target market: 2004 – Q3 2008



Source: Unaudited data, Banking Association
Note 2008 data for Q1-Q3 only

Over 230,000 mortgages were granted in the FSC target market between 2004 and the end of the third quarter in 2008. Using this data together with data from sources discussed above it appears that FSC lending accounts for around 15% of households with a mortgage (assuming there are 1.4 million households with a mortgage as per the 2007 Community Survey) and approximately 4% of mortgage assets using an estimate of R651 billion of outstanding residential mortgage credit extended to households as at September 2008[15]. These loans are likely to have a higher risk profile than loans granted to higher income households – particularly in the case of high Loan-to-Value ("LTV") mortgages granted at the trough of the interest rate cycle in mid-2006. However given available data we do not have a sense of how these are performing relative to the higher value loans in light of the pressures of the current economic environment. Certainly, data with respect to delinquencies and defaults, collected by market segment, would help lenders better understand the actual risk profile and underlying drivers that apply to the market.

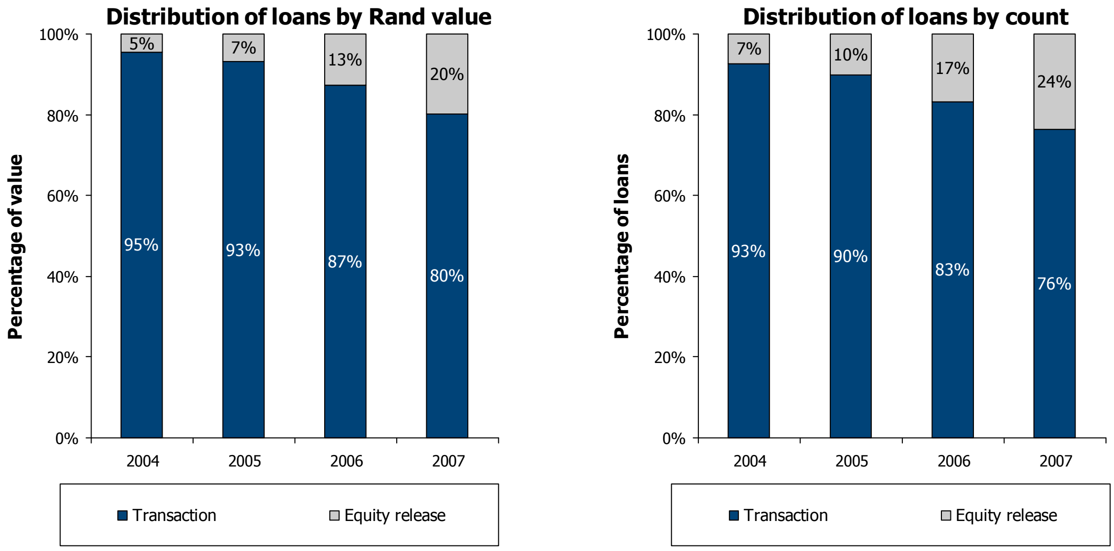
It is noteworthy that while house prices in the affordable segment have been rising (see Chart 6. above) the average loan value of FSC mortgages has declined since 2006. While BASA does not

---

[15] In May 2007 the first-lien subprime market in the USA was thought to account for approximately 14% of first-lien mortgages. It is a mistake to compare FSC borrowers (who fall within the FSC target market by virtue of their income alone) with sub-prime borrowers in the US, which the World Bank defines as follows: 1) a FICO (or credit) score of 660 or below, 2) two or more 30-day delinquent payments in the past 12 months, or one 60-day delinquency in the past 24 months, 3) a foreclosure or charge-off in the past 24 months, 4) any bankruptcy in the last 60 months, 5) qualifying debt-to-income ratios of 50 percent or higher, 6) limited ability to cover monthly living expenses. However, the high LTVs that applied to sub-prime loans in the US are similar to those that applied to FSC loans in South Africa.

monitor the profile of FSC loans with respect to equity release loans compared to transaction-based loans, a high-level analysis of deeds office data indicates a growing proportion of the former[16]. While this may indicate increased home improvement investment by existing home owners, an hypothesis that FinScope data appears to support[17], it might also indicate greater propensity of households to use mortgage finance as a cheaper source of consumer credit, or as a mechanism to 'cash-out' of their housing investment.

Chart 8. Transaction-based Vs. equity release mortgages in the FSC target market



Source: Deeds office data sourced from Lightstone
Note: :Records where there is no transaction value and where the bond registration is one year or more after the sale are regarded as equity release loans

Irrespective, while the trend should be monitored, it does not appear that it can satisfactorily explain the fluctuation in average loan values from year to year.

A summary of deeds office data by loan value is provided below. More striking than the increase in low value loans between 2006 and 2007 is the significant decline in the value and number of loans in excess of R180,000 originated within the FSC target market in 2007. The decline in

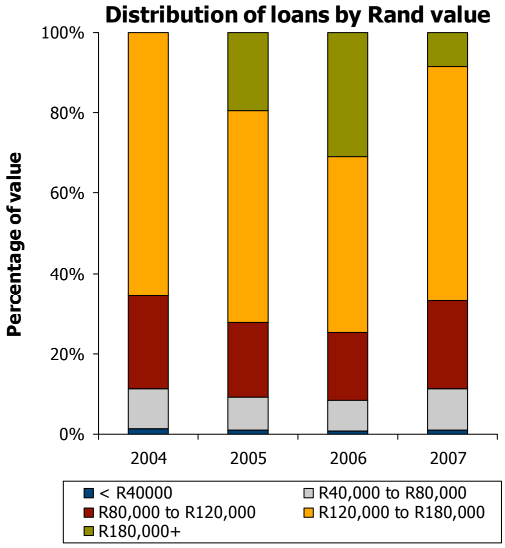
---

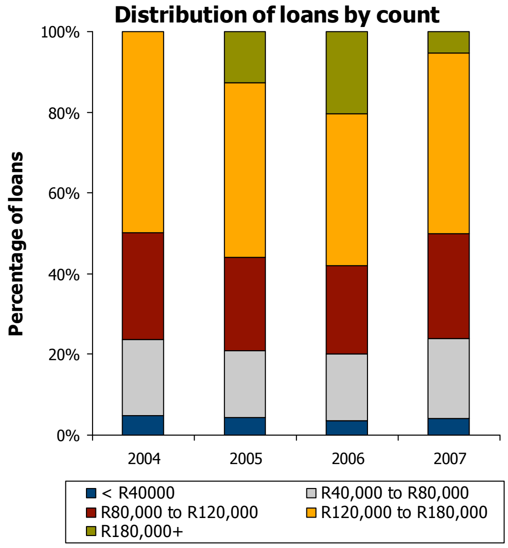
[16] An equity release loan is identified by a mortgage granted on a property where there was no corresponding sale. In order to identify FSC loans an affordability threshold was calculated based on the average prime interest rate in a given year using a 25% instalment-to-income ratio. Only loans granted by the big four banks to individuals were included. Loans on high value properties (in excess of R450k) were excluded

[17] According to FinScope in 2004 roughly 464 000 adults in the FSC target market said they were investing in improving their homes while in 2007 557 000 adults said they were investing in improving their homes. It should be noted that the data is not stable. In 2006 164 000 people in the FSC target market were investing in home improvements. As a percentage of the market, the percentage of adults who said they were investing in improving their homes was the same in 2004 and 2007 at 5.2%. The question in the survey is "which of the following are you currently investing in or putting money into?.. Improving your home"

average loan size clearly reflects the diminished capacity within the market to afford larger loans as prime interest rate increased from 12% in December 2006 to 14.5% in December 2007.

Chart 9. Breakdown of mortgages by mortgage size in the FSC target market





Source: Deeds office data sourced from Lightstone
Note: In order to identify FSC loans an affordability threshold was calculated based on the average prime interest rate in a given year using a 25% instalment-to-income ratio. Only loans granted by the big four banks to individuals were included. Loans on high value properties (>R450k) were excluded.

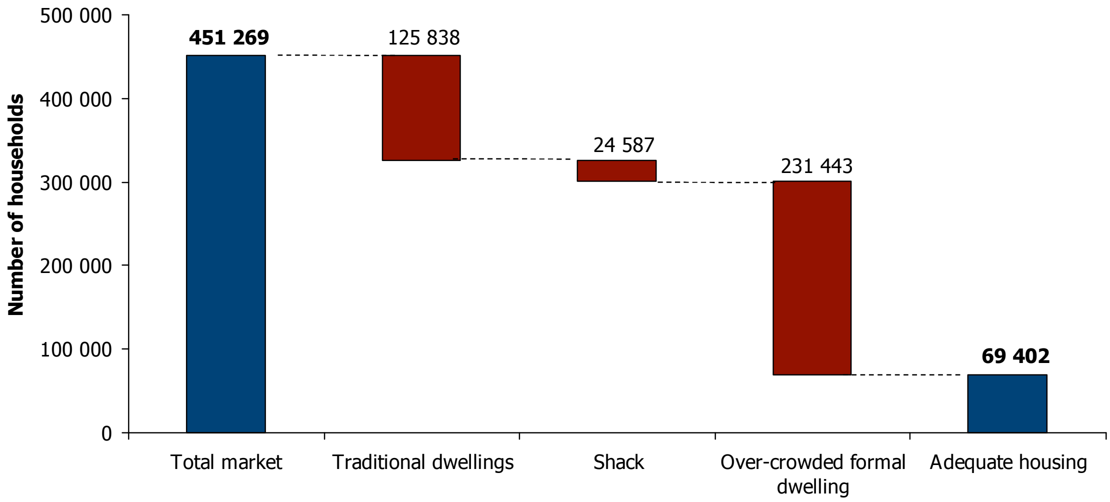
Given rising costs of newly built houses and a relatively small, albeit growing share of equity release loans many lower value mortgages are in all likelihood funding transactions on the resale market where prices appear to be lower than newly-built houses. While this highlights the opportunity to stimulate that market, given stock shortages and limited supply of affordable newly built units the sector's growth is likely to be constrained. Without new stock the gaps along the housing ladder will prevent households from moving upwards.

4.2 Too poor – the Market Redistribution Zone

While the FSC target market is intended to encompass lower income rather than very poor households, the use of household income to characterise the market obviously ignores critical factors such as household dependency ratios and income certainty. According to FinScope 2007, 21% of adults (16+) in the FSC target market say their households often or sometimes go without enough food to eat. 15% say their household often goes without a cash income (a further 27% sometimes go without cash income). According to the IES per capita incomes (i.e. income per person) in almost 10% of the households in the FSC market are below R10 per day. For the purposes of this analysis these households are deemed to lie in the Market Redistribution Zone.

Over 95% of the households in this zone have an income of below R3,500 per month, the cut-off for eligibility for a subsidised house. However assuming a stable household unit[18] only 35% would qualify for housing subsidies as the majority are either single person households or they already own a formal dwelling. 60% of the market lives in rural areas. Data from the IES has been used to characterise housing conditions in the Market Redistribution Zone as shown below. Of the 450,000 or so households in the market 250,000 live in shacks or over-crowded formal dwellings. A further 125,000 live in traditional dwellings, many of which may be inadequate.

Chart 10. Housing conditions in the Market Redistribution Zone



Source: IES 2005/2006
Overcrowded: More than two people per room

4.3 Access constraints in the market development zone

In order to assess access to mortgages a range of assumptions are required relating to the interest rate, the size and the term of the loan. While the first two fluctuate a standard assumption of a twenty year bond has been assumed throughout the analysis.

Interest rates and house prices have varied considerably since January 2004 when the FSC was introduced. At 10.5% prime interest rates were at historic lows between May 2005 and June

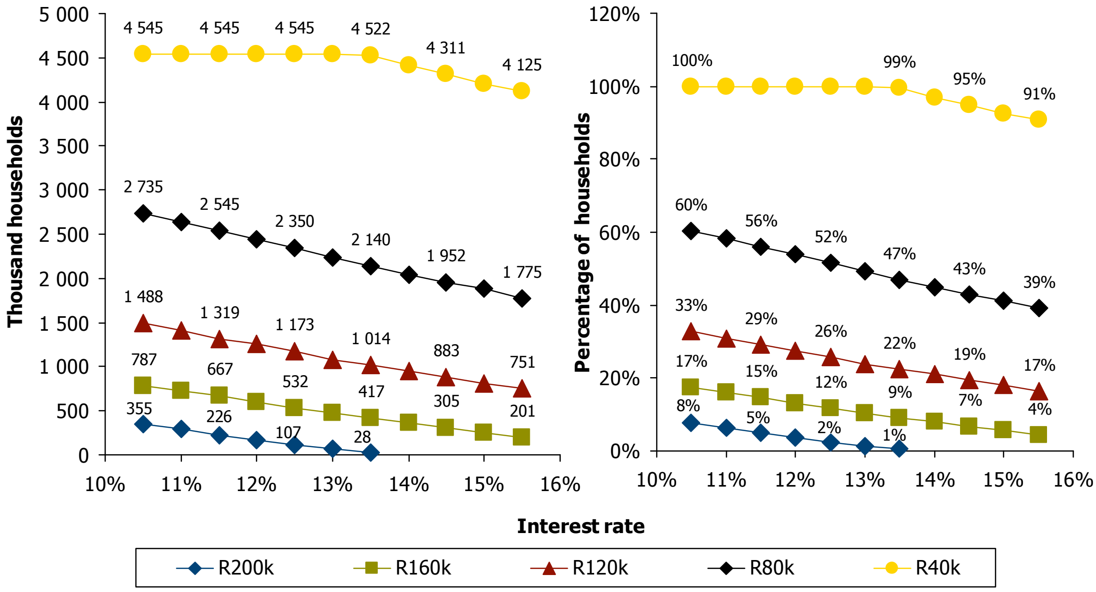
[18] It is noted that household units as they exist are not necessarily optimal from the perspective of household members. The process of household formation responds to various factors, including the availability of housing and housing subsidies

2006. Rates began to rise steadily from July 2006 to reach a peak of 15.5% in June 2008. They have only recently begun to decline as inflationary pressures have abated. Market expectations are that they will decline further to reach 12% by the end of 2009[19].

House prices in the affordable segment of the market also increased, at least initially putting further pressure on affordability. Of course the availability of mortgage finance coupled with static supply no doubt played a critical role in that trend.

The chart below maps the impact of both house prices and interest rates on the "addressable" market size assuming a simple 30% instalment-to-income ratio. The increase in prime interest rates from 10.5% to 15.5% (assuming mortgages granted in the market were made available at prime rate) has effectively halved the market for a mortgage of R120,000 from almost 1.5 million households to 751,000 households. At 15.5% no households in the target market can afford an instalment on a R200,000 mortgage.

Chart 11. Market size for various mortgage sizes by interest rate (excluding those who already have a mortgage as well as those who are in the market redistribution zone)



Source: IES 2005/2006
* Calculated for a bond term of 20 years, instalment = 30% of gross household income

[19] See Nedbank Guide to the Economy, 19 January 2009 ISSN 1023-7097

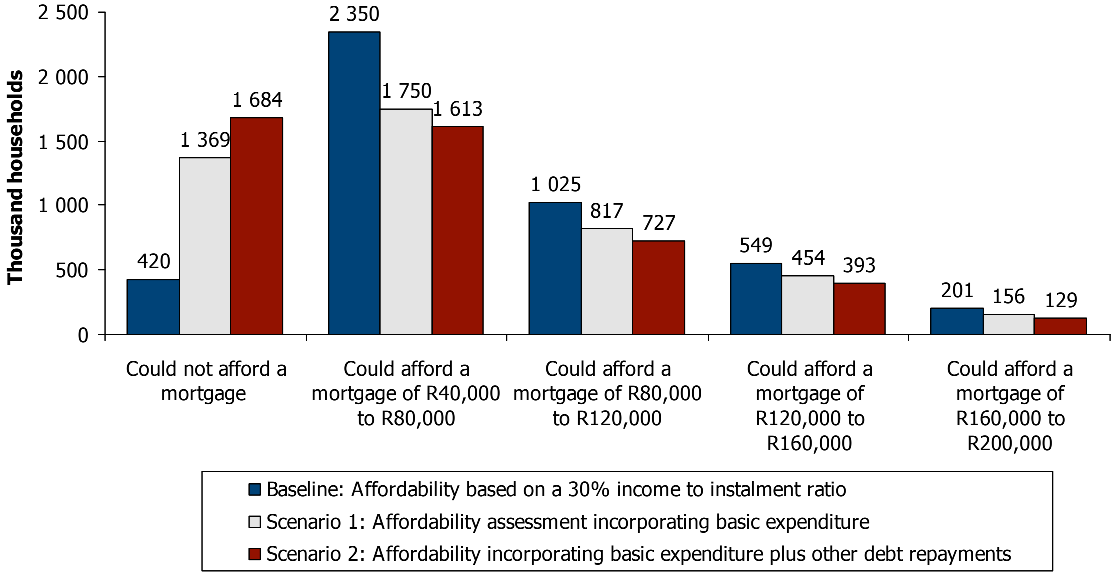
Another critical factor impacting on access levels is the introduction of the National Credit Act. The Act requires lenders to take reasonable steps to ensure that borrowers can afford to repay loans at the time they are granted. This presents a departure from standard practice of assessing affordability on the basis of an income-to-instalment ratio alone, typically 30% of gross income in the case of mortgages. Lenders must now establish what other financial commitments households have, including existing debt as well as other typical household expenditure.

Detailed expenditure data from the IES together with data on outstanding loan balances have been used to estimate the impact of this change. While the IES under-reports debt usage in general it indicates that in 2006 just over half of all households in the target market had an outstanding loan at a clothing or furniture retailer[20]. An affordability assessment that incorporates these commitments will clearly be more restrictive than one that is based on an income-to-instalment ratio alone.

The baseline scenario in the chart below uses data from the IES to provide a breakdown of the potential market size for a mortgage of varying amounts assuming a 20-year mortgage financed at an interest rate of 15.5% using a 30% gross instalment-to-income ratio. Under that scenario approximately 750,000 households could access a mortgage of R120,000 or more. A further one million could obtain a mortgage for between R80,000 and R120,000.

[20] Vehicle financing is relatively uncommon. According to the IES 4% of households with an income of between R3,500 and R7,500 have a vehicle loan from a bank

Chart 12. Mortgage affordability scenarios: FSC target market excluding those who already have a mortgage and those in the market redistribution zone



Source: IES 2005/6
* Mortgages calculated for a 20 year term at an interest rate of 15.5%

Scenario 1 above illustrates the impact of incorporating expenditure related to basic household needs such as food, clothing, transport and education on affordability. The analysis assumes that households should allocate no more than 70% of disposable income to these basic expenditure items plus their mortgage instalment. This scenario *does not incorporate financial commitments associated with other existing debt* in the determination of affordability. It illustrates that while the incorporation of basic expenditure impacts on affordability in all segments it has the most significant impact on households at the lower end of the market shifting approximately 25% of those who might have had access to (but apparently could not afford) a mortgage of between R40,000 and R80,000 out of the market[21]. The constraint also has an impact at the upper end of the market, shifting approximately 23% of those who could have accessed a mortgage for R160,000 or more into a lower tier. It is worth noting that food expenditure appears to be understated by the IES. Further the share of expenditure allocated to basic items is likely to be higher today than it was in 2006 given increases in the cost of food and transport. Together these observations imply that the scenario presented above is a best-case one.

[21] In this analysis it is assumed that the lowest feasible value for a mortgage is R40,000

Adding to this the commitments arising from existing loans (based on data in the IES on outstanding loan balances) further diminishes the market as illustrated in Scenario 2[22]. The difference between Scenario 1 and Scenario 2 highlights the impact of usage of other formal credit on access to mortgage finance. While it does restrict access it is perhaps less dramatic than what might be expected. Once again, a proviso is worth noting; the IES dramatically under-estimates consumer credit usage. The true impact on access to housing finance of consumer credit is in reality likely to be more significant than highlighted by the analysis.

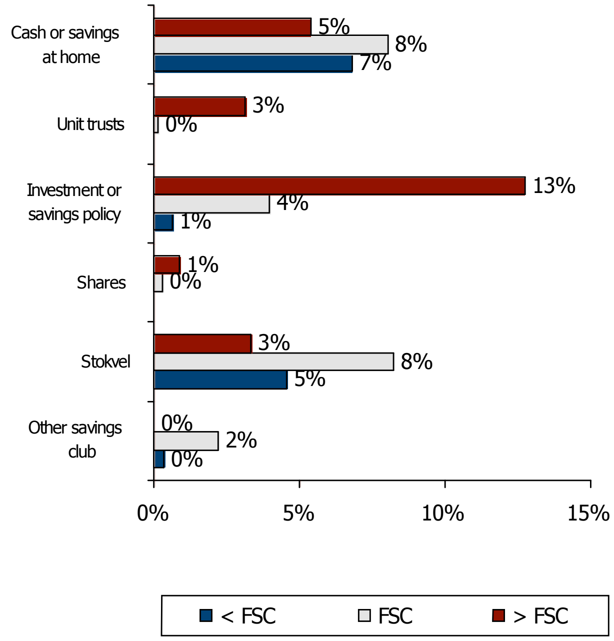
A comparison between the baseline scenario and Scenario 2 quantifies the impact of the National Credit Act on access to mortgage finance. It is worth highlighting that while access levels are obviously lower with the Act than without it this is not necessarily indicative of an access problem. Quite the opposite – without the Act there may well have been too much access, a problem whose consequences are all too apparent in the context of the global credit crisis.

A final development in the mortgage market is the declining Loan-to-Value ratios. In 2006 most banks provided 108% mortgages as long as some collateral guarantee was in place. This has begun to change as banks tighten their lending policies. At the time of writing, maximum Loan-to-Value ratios at Standard Bank for affordable houses had declined to 95%. Assuming a further amount of 8% of the purchase price is required for transaction costs, a deposit of R26,000 would be required for the purchase of a R200,000 house.

The decline in LTV (and the withdrawal of cost inclusive mortgages) has obvious implications for the target market: only those with savings or those who are trading an existing house can access a mortgage. According to FinScope 2007 very few adults in the target market appear to have savings products (the survey provides no details on the amount people have saved).

[22] The IES contains data on outstanding loan balances but does not contain data on instalments for all categories of loans. In order to calculate instalments a range of assumptions has been used in connection with the outstanding term of the loan and the interest rate. Details of these assumptions can be found in "INDEBTEDNESS IN SOUTH AFRICA – WHAT THE INCOME AND EXPENDITURE SURVEY CAN (AND CAN'T) TELL US", August 2008, Prepared for the FinMark Trust by Eighty20 (see http://www.finmark.org.za/documents/R_Eighty20.pdf)

Chart 13. Savings product usage (percentage of adults 16+)

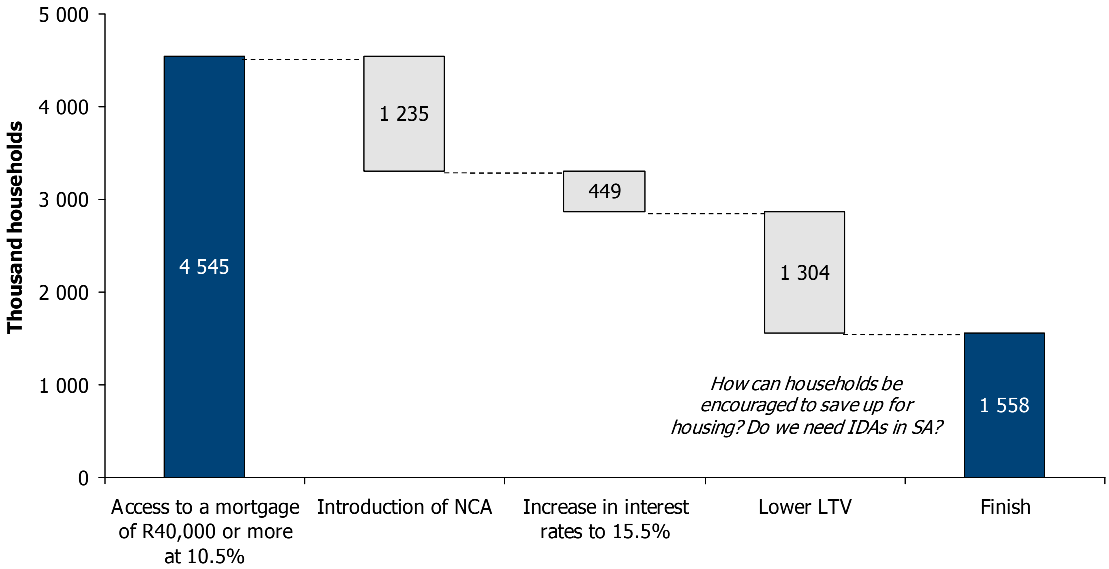


Data on household savings product usage from the IES highlights this too. That survey finds that while 23% had deposited money into a savings account and 15% of households had contributed to a stokvel[23] in the year prior to the survey, the percentage of households with other investment assets was negligible (2.4% contributed to investment plans or policies and 0.3% to unit trusts).

The impact of these three shifts in the market (that is interest rate increases, the introduction of the NCA and the introduction of lower LTVs) is a dramatic increase in the size of the Market Development Zone – a misnomer given the limited scope to develop the market independent of a significant decrease in interest rates or an increase in the availability of capital in reality exists. The chart below summarises these shifts on access to a mortgage of R40,000.

[23] A stokvel is the South African term for an informal savings club or association. There is no indication in the survey as to whether this is a rotating (ROSCA) or accumulating (ASCA) association. There is also no indication as to whether bank deposits are accumulated over the long term or depleted to meet more short term needs.

Chart 14. Impact of market shifts on access to a mortgage of R40,000



In 2006 when prime was at 10.5% and affordability criteria were based purely on a 30% instalment-to-income ratio all households bar the 450,000 or so who lie in the Market Redistribution Zone technically had access to a mortgage of at least R40,000. The incorporation of the household's other financial commitments in the determination of affordability, a requirement of the NCA, had a noticeable impact on access. Holding interest rates constant to isolate its impact, 1.2 million households or almost a quarter of households in the target market would be unable to access a mortgage because of this development alone. Of course interest rates were not held constant. The impact of the shift in prime rate from 10.5% to 15.5% was to curtail access for a further 450,000 households (9% of the market) and to shift affordability thresholds downwards for those households who remained in the enablement zone. Finally, the introduction of lower LTVs has restricted access further, removing another 1.3 million households (25% of the market) who do not own a mortgageable dwelling and who appear to have no savings from the enablement zone.

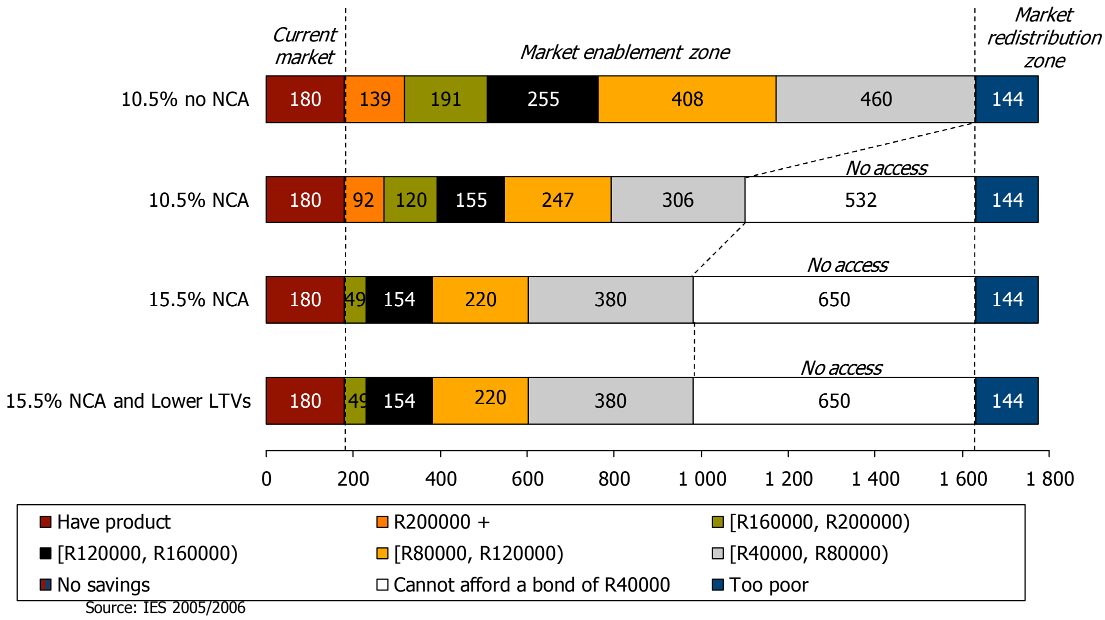
All in all around 1.6 million households in the target market do not have a mortgage but appear to have access to a mortgage of R40,000. Of course there are unlikely to be very many houses on sale for this amount. As already noted the most basic newly constructed houses in urban areas cost in the region of R250,000. In 2006, corresponding to the time the survey data was collected, the average cost of an affordable house (defined by ABSA as 40-79m^2 and costing less than R400,000) was R216,722. Given house prices, access to a R40,000 mortgage on its own is unlikely to be able to fund the purchase of a house. However, equally true is the observation that for households that already own mortgageable properties the value of the mortgage need not equate to the value of the house. In assessing the potential market for mortgages the target market has therefore been segmented into those households that own properties which appear to be mortgageable, principally formal structures located in urban areas[24], and those that do not. Those that already own mortgageable properties can access mortgages on their existing houses or can more easily sell their properties and trade up using a mortgage. For this market there is a real distinction between the value of the mortgage they require and the value of the house they might wish to buy. According to the IES approximately 1.8 million households in the target market (34% of households) own what appear to be mortgageable properties.

For those that do not own mortgageable dwellings and have no other savings the value of the mortgage they can afford is in effect the value of the house they can purchase. According to the IES 3.4 million households or two thirds of the market fall into this sub-segment.

The chart below illustrates the impact of changes in the credit law and increases in interest rates on access to mortgage finance for the sub-segment of the market that appears to own mortgageable properties. In that segment lower Loan-to-Value ("LTV") ratios have no impact on access as households have capital in their existing properties. The analysis indicates that roughly 800,000 households (45% of households in this segment) cannot access a mortgage because they are too poor, or more commonly because they do not have capacity to meet the instalments on a R40,000 mortgage. At the other end of the spectrum around 200,000 households (11% of the households in this segment) could access a mortgage of R120,000 or more.

[24] The tenure of rural dwellings is uncertain. According to the IES, approximately 1.2 million households (23% of the target market) own dwellings in rural areas

Chart 15. Access frontier for a mortgage for households that own mortgageable properties and therefore have equity to support the lower LTVs (thousand households)

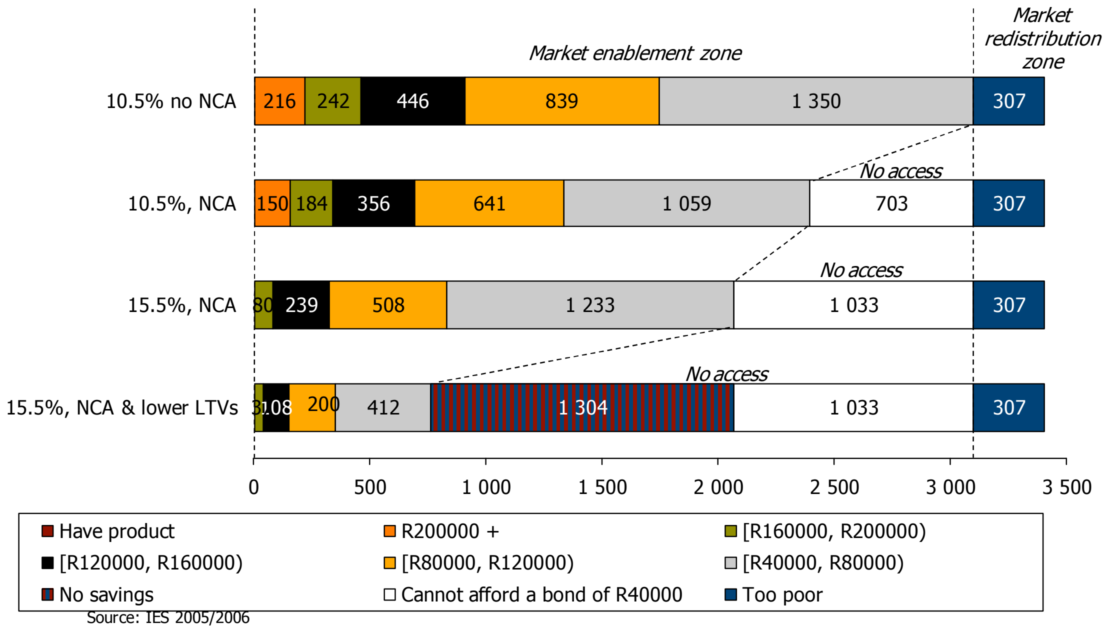


Source: IES 2005/2006

Within the segment of the target market that does not own mortgageable properties, access is noticeably constrained. Not only is affordability a critical barrier but capital constraints, manifested in lower LTVs, have a significant impact on access.

As with households that own mortgageable properties a sizeable segment do not have access, in this case around 40% or over 1.3 million households, either because they are too poor or because they cannot afford the instlaments on a R40,000 mortgage. A further 1.3 million households cannot access the product because they have no capital for a deposit. Together these constraints impact on almost 80% of households in this sub-segment. Less than 150,000 households (around 4% of the sub-segment) can access a mortgage of R120,000 or more.

Chart 16. Access frontier for a mortgage for households that do not own mortgageable properties and must therefore have savings (thousand households)



Source: IES 2005/2006

The analysis highlights the importance of encouraging first-time home buyers to accumulate savings for a deposit. In this regard matched savings initiatives targeting lower income households, such as Individual Development Accounts available in the USA[25], may be of interest.

Given quantifiable affordability constraints, two thirds of the market is unable to access a mortgage of R40,000 or more.

In summary, across the two segments of the market, using access constraints described above that relate to quantifiable affordability constraints, two thirds of the market is unable to access a mortgage of R40,000 or more. There are, however, other factors that impact on access. These include awareness issues relating to mortgages specifically and credit markets in general. Data from FinScope highlights key challenges with regard to the former. While almost two thirds of adults in the market say they understand what a mortgage, bond or home loan is, only 51% say they understand what a bad debt is. When asked about rights and responsibilities associated with the National Credit Act, 12% think that the statement "You have the right to miss up to six payments in any yearly cycle" is correct. A staggering 55% say they do not know if this is correct[26].

[25] To read more on IDAs see; "Individual Development Accounts: How Legislators Can Use IDAs as a Tool to Increase Homeownership and Promote Asset Development", National Council for State Legislature, August 2005 http://www.ncsl.org/programs/econ/housing/IDAshousing05.htm

Lack of formal title places households beyond the reach of the mortgage market. While there is no recent survey data to assess the extent of this constraint[27], there is abundant anecdotal evidence that many households in the target market continue to transact using informal mechanisms.[28] In some cases the use of informal property markets may arise if the household is prevented from transacting using formal mechanisms or if the costs of doing so outweigh perceived benefits. Barriers might include the pre-emptive clause preventing subsidised housing recipients from selling their homes for a minimum of five years, or the existence of outstanding municipal arrears. In that regard according to the IES, of the 1.8 million households in the target market who own what appear to be mortgageable dwellings almost 30% are in arrears on their municipal bills. In 10% of households who own mortgageable properties arrears exceed R5,000. Lack of awareness of the benefits of and requirements for transacting using formal mechanisms are likely to be critical factors inhibiting participation in formal property markets. Households that are not well informed of the benefits of using formal mechanisms to transact are unlikely to be able to make optimised choices as to how to transact nor are those who do not know how to access formal mechanisms.

4.4 Implications of the analysis for FSC lending targets: Mortgages

In order to get a sense of the market activity we can expect, the market has been segmented into three sub-segments described in the table below. The first two segments emanate from the market that already own mortgageable properties. These households can use their properties to trade up or to access equity. The third segment consists of households that are first-time buyers. As already noted, access and affordability are particularly constrained in this sub-segment. The table also provides a ballpark estimate of the size of the segment measured in the number of mortgages originated / used and associated Rand values based on a range of assumptions.

---

[26] The data highlights that this is a problem in higher income markets too. According to the survey 17% of adults whose household income exceeds the FSC upper threshold think the statement is correct while 42% don't know

[27] The 2004 FinScope survey found that 14% of adults who own formal dwellings in the FSC target market did not know if they had written proof of ownership. 4% did not have written proof of ownership. (61% had written proof of ownership of the land and building while 21% had written proof of ownership for land or buildings)

[28] In 2007 and 2008, Urban LandMark undertook research into how the poor access, hold and trade land, which found evidence of informal (i.e. off register) transactions. See http://www.urbanlandmark.org.za/docs/Additional_Quantitative_Analysis_Report.pdf

Table 2. Mortgage usage segmentation

Segment name	Description	Key assumptions	Number of mortgages and annual value (2006 Rands)
Trading-up	Households who own mortgageable properties and use a mortgage to trade up	Minimum mortgage required: R80,000, average mortgage is R100,000 Churn: 4%[29] of households that can access a mortgage of R80,000 or more	24,000 mortgages R2.4 billion
Cashing out	Households obtain a mortgage on their existing mortgageable properties (i.e. for home improvements) or who withdraw equity from existing mortgages (i.e. to finance other purchases)	For every four households who trade up (as described above), one will 'cash-out'[30] On average they withdraw R80,000	4,800 mortgages R384 million
First time buyer	These households purchase houses on the secondary market (No first time homebuyer in the FSC market can currently afford to buy a newly constructed house)	Can only buy houses sold by those who trade up They require a mortgage of at least R80,000 with the average at R120,000	24,000 mortgages R2.9 billion

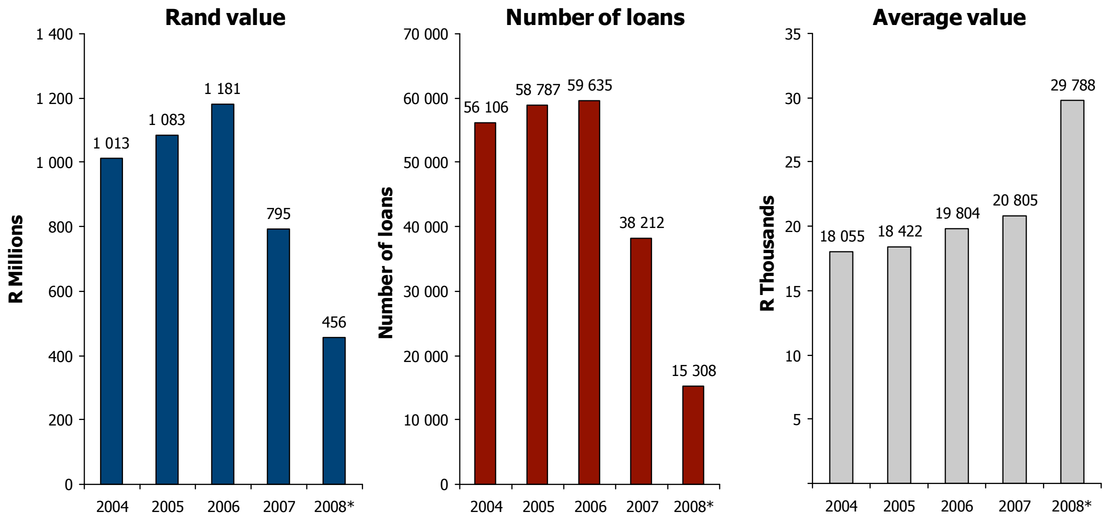
[29] According to the 2008 All Media and Products Survey 4% of adults in the FSC target market who own formal dwellings in urban areas say they have moved house in the past 12 months
[30] This is in line with the estimates of current activity in the FSC target market

Altogether the three segments generate roughly R5.2 billion Rands worth of activity measured in 2006 Rands (approximately R6.35 billion in December 2008 Rands). On the basis of these assumptions, a five-year mortgage origination target of R32 billion appears to be reasonable. It is worth noting that the determination of this target does not explicitly account for key risks such as deteriorating economic conditions and large-scale retrenchments. Aside from reducing lender appetite to originate loans these risks also diminish the willingness to use the product of those who might have access to it.

5 ACCESS TO PENSION-BACKED LOANS IN THE FSC TARGET MARKET

The access frontier methodology again guides the analysis of access to pension-backed loans. There is no survey data with which to assess the size of the current market. According to unaudited data from the Banking Association shown below, over 228,000 Pension-Backed Loans ("PBLs", also known as Fully Guaranteed Loans), amounting to over R4.5 billion, had been originated by the large banks between 2004 and the end of the third quarter of 2008.

Chart 17. Pension-backed loan origination in the FSC target market: 2004 – Q3 2008



Source: Banking Association of South Africa
Note 2008 data for Q1-Q3 only

A cautious note has been raised by the Financial Sector Charter Council with regard to loans granted to individuals such as PBLs and unsecured loans, explored in more detail in the chapter that follows. For those products, affordability is determined based on an individual's income rather than the household's income. Lenders therefore do not capture data about household income and personal income is used as a proxy to assess whether the loan falls into the FSC target market. It is therefore likely that a proportion of FSC loans in fact lie outside the span of the target market. To quote from the 2005 FSC Council Annual Report[31] "Most institutions continue to base decisions on the income of individual borrowers, although continuing to use the R1 600-R7 900 Charter qualifying bracket. The potential result of this approach is significant bracket-creep: loans being made to households in which one earner (the borrower) is at or near the ceiling of R7 900 and the income of second or third earners are not taken into account,

[31] 2005 Annual Review of Transformation in the Financial Sector, Financial Sector Charter Council

although the combined income pushes the household above the Charter's R7 900 ceiling, moving the household up one or more earning brackets."

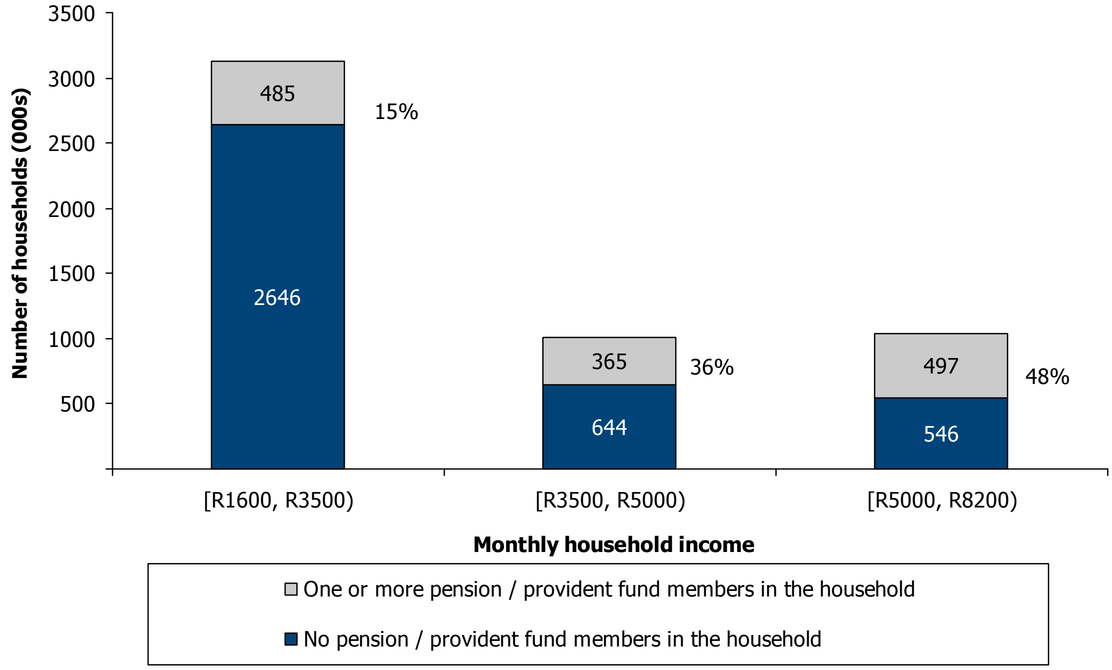
In the case of PBLs some attempt is made by the lender to verify that the purpose of the loan is for housing purposes, although it has been noted that borrowers can, and in some cases do, purposefully mislead lenders in order to access credit on very attractive terms.

The impact of the NCA, introduced in June 2007, is clearly visible in this market. Prior to the Act lenders typically relied on a standard affordability threshold using a ratio of 25% or 30% of gross income as the maximum instalment-to-income ratio. Because the loans are fully guaranteed no additional investigation into affordability was undertaken. The significant reduction in the volume of loans from over 59,000 in 2006 to around 38,000 in 2007, and just 15,000 loans for the first three quarters of 2008 in all likelihood reflects more stringent affordability requirements in line with the Act.

A necessary, albeit insufficient[32], condition for access to PBLs is that at least one person in the household is an active pension or provident fund member. Within the FSC target market data from the IES indicates that around one quarter of households in the target market corresponding to 1.3 million households meet this condition. The chart below summarises this basic access requirement within the various income sub-segments of the FSC market. Higher income households are significantly more likely to have an active pension or provident fund member than households lower down the income spectrum.

[32] Employers and fund administrators also must agree to facilitate payroll deduction and use of pension assets as guarantees

Chart 18. *Pension / provident fund membership in the FSC target market*



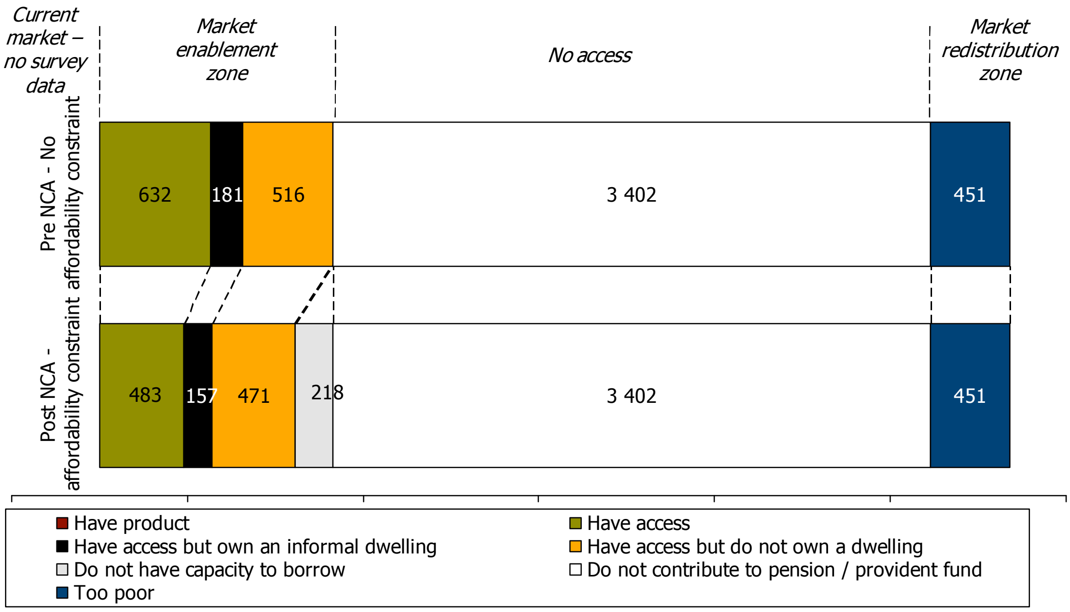
Source: IES 2005/6

In most cases PBLs are used to finance incremental housing development. Product providers typically require some proof that the product will be used for housing. However borrowers do not need to prove they own their dwelling nor that the dwelling is a formal structure. While many households that do not have secure tenure may be unwilling to put their retirement assets on risk to invest in improving their homes, those that do may well be subverting the national housing cause as defined by policymakers. Technically there would be nothing to stop employed residents of an informal settlement from using a PBL to formalise the structure of their homes[33]. Dimensions relating to homeownership and dwelling type are therefore included in the access frontier analysis.

Two access scenarios are shown below. The first illustrates the frontier prior to the introduction of the NCA while the second illustrates access after the introduction of the NCA (note the additional category, "do not have capacity to borrow"). As with the access frontier for mortgages, it is assumed that those households with per capita incomes of less than R10 per day lie in the Market Redistribution Zone.

[33] It is noted that household-led investment in informal areas that are suitable for human settlement and not over-crowded often (although not always) leads to policymakers formally recognising the settlement as permanent and formal.

Chart 19. Access frontier for a pension-backed loan in the FSC target market (thousand households)



Source: IES 2005/2006

As illustrated above, roughly 1.1 million households either already have the product or might have access to PBLs. Of those that have access 56% do not own formal dwellings and may have reduced incentive to borrow for housing purposes. While this is likely to reduce usage, this is not, strictly speaking, symptomatic of an access to finance problem per se.

Around 220,000 households have access to the required underlying security but cannot access the product because they are over-extended. It is noteworthy that the reduction in access as a result of the more stringent affordability criteria associated with the NCA illustrated above appears to be far less pronounced than what might be expected given the very significant decline in volumes evidenced by supply-side data from BASA (the number of loans originated dropped by 35% between 2006 and 2007). While other supply- or demand-side factors may have impacted on the propensities of lenders and potential borrowers to grant or use credit respectively it is worth noting that the survey data in all likelihood understates household indebtedness levels significantly. The supply-side evidence lends credence to the view that many more households than the survey data would suggest are unable to absorb additional credit.

A critical constraint that is not captured by the analysis is awareness on that part of those that might have access that the product exists. There is no data to assess the impact of this constraint but in line with other data that indicates low levels of awareness in the target market relating to credit products in general (already highlighted in the analysis of access to mortgages above) it is likely that relatively few people in the target market are sufficiently aware of the benefits of the product to access it.

At this stage in the economic cycle, there is less likely to be the appetite on the part of lenders to expand the market significantly, at least not until economic conditions improve. Looming retrenchments in many sectors is likely to significantly diminish the willingness to lend[34]. Further, securitisation has been an important mechanism to raise funding, particularly for non-bank lenders. The dramatic fall off in investor appetite for securitised assets is likely to severely impact on the ability of these lenders to access capital. Finally, the decline in the All Share Index of around 30% since January 2008 means that some PBLs may be 'under water' to borrow a phrase from the mortgage market[35]. Aside from triggering a reassessment of the value of existing guarantees and a revision of loan to market value ratios, given that the value of the underlying assets backing the guarantee has declined the value of loans will decline in tandem.

5.1 Implications of the analysis for FSC lending targets: Pension-backed loans

While the data indicates significant market potential (estimated at over 1.1 million households) for the product, actual origination, currently at around 20,000 loans per annum, is comparatively low. As noted, the analysis in all likelihood overstates access. Barriers to access relating to affordability are most certainly understated while employer or fund administrator-initiated limitations on access, as well as key demand-side barriers such as awareness are not quantified. An estimate of the market potential for this product is therefore based principally on Banking Association data.

It is assumed that on average over the course of the next phase of the FSC lower volumes are attained in line with annualised 2008 data. A simple extrapolation indicates that around 20,000 loans were granted in that year by the big four banks. Given the impact of the decline in the value of retirement portfolios it is assumed that average loan values retreat to 2006 nominal values of R19,800 bringing an annual origination estimate to just over R400 million in current Rands.

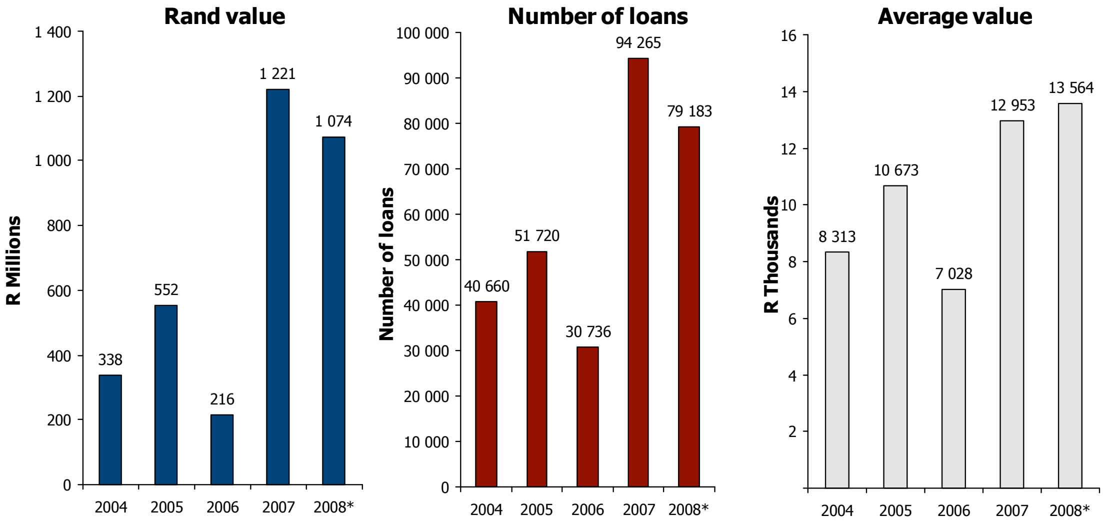
[34] Looming retrenchments are also likely to reduce the willingness to borrow. However this too is not an access issue
[35] Lenders can claim any shortfalls from the borrower if the guarantee is insufficient

6 ACCESS TO UNSECURED HOUSING LOANS

Households in the target market that are not already over-committed can theoretically obtain unsecured micro loans to create housing assets incrementally. The product is regarded as a critical input in the process of developing housing assets that can become mortgageable over time.

According to BASA data unsecured housing loans to the value of R3.4 billion were originated between 2004 and the end of the third quarter in 2008.

Chart 20. Unsecured housing loan origination in the FSC target market: 2004 – Q3 2008



Source: Unaudited data, Banking Association
Note 2008 data for Q1-Q3 only

There are some limitations regarding the available data on unsecured housing loans. As with PBLs data on FSC lending activity is based on personal income rather than household income, potentially skewing reported activity. Further, there is limited verification that the loan is used for housing. Based on conversations with lenders it appears that the determination of loan use is based on a borrower declaration. However, this is not verified. There is consequently no detailed data on what loans granted by the FSC signatory banks are used for nor are there clear specifications regarding what constitutes a housing loan. While it would be interesting to researchers and perhaps even useful to lenders[36] to analyse more detailed data relating both to household income and loan use the information cannot be easily (or cheaply) verified. It is therefore not regarded by lenders as being sufficiently useful to warrant systematic collection during the loan origination process.

The BASA data highlights that, in contrast to mortgages and PBLs, volumes and average values have increased significantly since 2006. In terms of volumes it is not clear whether this reflects higher access or usage levels in the market as a whole or a shift in the market shares of various unsecured housing finance providers in favour of the big four banks in line with a greater focus on this product within these institutions. FinScope data cannot shed light on the matter. The survey does not specifically gather data on unsecured housing loans provided by banks while data on loans from microlenders to purchase or improve a house is poorly captured by the survey (less than 0.2% of adults in the market say they have the product).

Given that loans are unsecured and that households in the target market by definition have an income the primary access constraint relates to the ability of households to absorb credit[37]. According to the IES approximately 22% of the households in the target market are already over-committed and cannot absorb further credit[38]. The cautionary note regarding data quality already highlighted in the discussion above on PBLs is worth restating – the IES understates indebtedness levels. A far higher proportion of households in the target market are likely to be over-committed. As with the analysis on mortgages and PBLs, those households with per capita incomes of less than R10 per day are assumed to be too poor for the product[39].

The analysis indicates that over 3.7 million households in the target market have the capacity to absorb additional credit and so have access to unsecured microloans. As with PBLs the analysis segments the market enablement zone into those that own formal houses and those that do not. One third of households in the enablement zone do not own a dwelling while a further 13% of

---

[36] The data is potentially very valuable from a strategic perspective. Those who borrow for housing purposes are likely to invest in improving their homes incrementally over many years, ultimately creating mortgageable stock that underpins the origination of more profitable secured loans. The ability to better understand and support the process may therefore be a source of competitive advantage for a housing lender

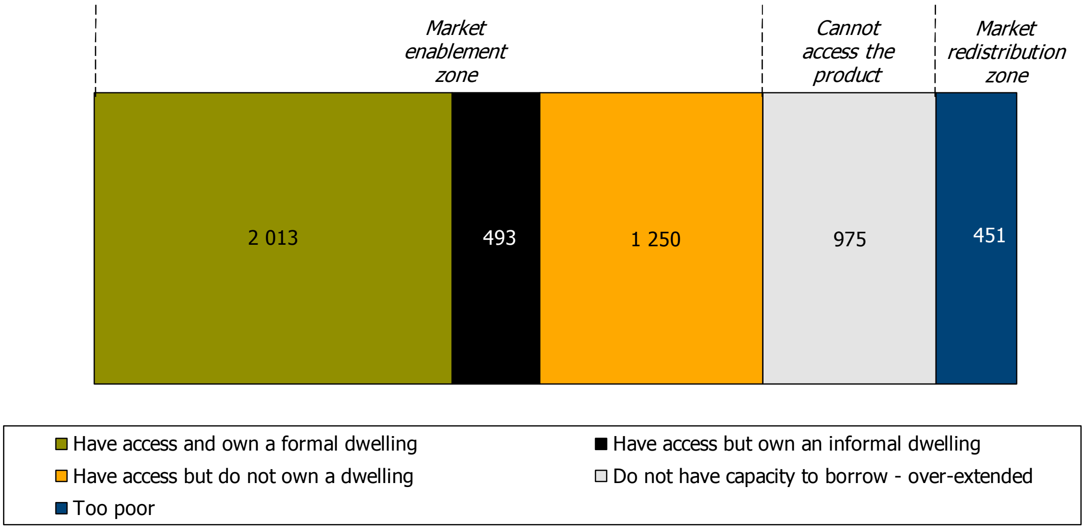
[37] Typically borrowers need to have a bank account to access the product. Other analysis of access to bank accounts indicates that access barriers for this product are low. No constraint in this regard has therefore been modelled

[38] It is noted that the number of over-committed households in the case of pension-backed loans and unsecured loans is higher than the number of over-committed households for mortgages. The reason relates primarily to the treatment of rental expenses. For those households who obtain a mortgage existing rental expenses are excluded from the analysis of affordability (the purchase of a house replaces the need to rent). For the analysis of access to unsecured loans and pension-backed loans it is assumed that rental commitments continue

[39] It is noted that housing micro loans are specifically intended to provide housing finance for the poor. Arguably the analysis should not incorporate a market redistribution zone

households in the enablement zone (493,000 households) own an informal dwelling. These sub-segments are of particular interest given the very limited access to the initial 'building blocks' required to commence the incremental housing process formally. Of course they may choose to invest in improving the quality of their homes regardless.

Chart 21. Access frontier for an unsecured housing loan in the FSC target market (thousand households)



Source: IES 2005/2006

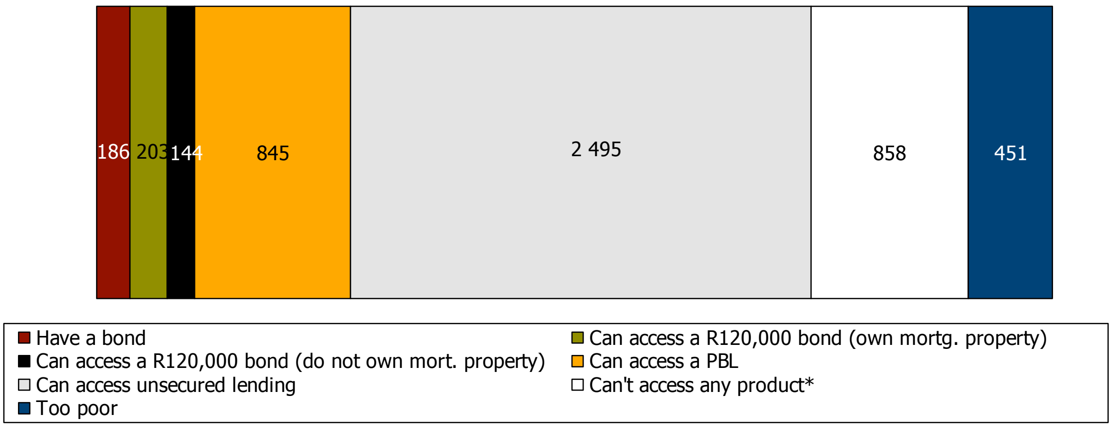
6.1 Implications of the analysis for FSC lending targets: Unsecured micro loans

In using the data to derive targets it would be prudent to assume that the market enablement zone is signficantly overstated. Further, given that verification of loan use is fairly difficult, increasing the target significantly relative to recent origination levels may simply serve to encourage households and lenders to categorise unsecured consumer finance, for which there is significant demand, as housing finance. Thus current lending activity, at around 105,000 loans per annum, is therefore regarded as a more useful indicator of likely future activity. Assuming both the volume of loans originated as well as the average loan values are maintained an annual target of R1.4 billion (in 2008 Rands) appears feasible.

7 A HOUSING FINANCE SPECTRUM IN THE FSC TARGET MARKET

A market view of access to housing finance is presented below. As a simplification, the analysis assumes a hierarchy of preferences beginning with mortgages to PBLs and finally to unsecured credit. It is noted that this ranking is more a reflection of lender preferences than household preferences. It also does not allow for hybrid products that combine both physical and financial assets as security. Neverthless in line with this, the continuum is presented as a set of mutually exclusive categories.

Chart 22. The housing finance spectrum in the FSC target market (thousand households)



Source: IES 2005/2006
* Sum of essential expenses (food, transport, housing utilities, and education) and formal loan repayments (bank, car, and retail debt) equal to or greater than 70% of the household's disposable income (gross income less tax). NB. Loan repayments calculated assuming 2/3 of the normal loan term remaining

Assuming that all households who can possibly access these various products do so, the total maximum value of the FSC housing finance market is estimated at approximately R87 billion using an average loan size of R120,000 for a mortgage, R19,8000 for a PBL and R11,500 for an unsecured loan (in 2006 Rands). Almost half of this is accounted for by mortgages while unsecured loans account for one third of the total potential market.

Clearly, not all households that can theoretically access housing finance products will choose to do so. The estimates based on the individual product targets described in the preceding chapters are therefore more realistic. These are summarised below:

Table 3. Projected annual origination targets in the FSC target market

Product	Annual number of loans	Average value	Total annual origination target
Mortgages	52,800	2006 Rands: R107,000[40] 2008 Rands: R130,700	2006 Rands: R5.66 billion 2008 Rands: R6.7 billion
Pension-backed loans	20,000	2006 Rands: R19,800 2008 Rands: R23,500	2006 Rands: R404 million 2008 Rands: R480 million
Unsecured	105,000	2006 Rands: R11,400 2008 Rands: R13,500	2006 Rands: R1.2 billion 2008 Rands: R1.4 billion
Total	117,800		2006 Rands: R7.26 billion 2008 Rands: R8.6 billion

Based on these assumptions a target of R43 billion in *end user finance* over five years appears realistic. Once again, the limitations of the analysis with regard to sentiment and the willingness to borrow are worth noting. Worth highlighting too is the observation that the lending targets developed above do not incorporate wholesale funding or developer loans.

[40] This assumes 24,000 first time buyers obtain a mortgage with an average value of R120,000, 24,000 households trade up using a mortgage of R100,000 on average and 4,800 households cash out on average R80,000 without trading their houses

8 BEYOND TARGETS

The analysis has focused primarily on determining a set of realistic, albeit high-level, targets for end user finance in the FSC target market. While this may be useful it is perhaps more important to reflect on what key insights the initial five-year period of the FSC can yield relating to access to housing finance, and critically, access to housing, both as shelter and as a leverageable household asset.

The analysis highlights a number of critical issues;

- ***Limited scope of mortgages given existing housing products***

Despite the banks meeting FSC lending targets, an achievement which required significant effort on the part of banks individually and collectively, the data does not indicate fundamental market deepening with regard to mortgages. The limited potential scope of access relative to the market as a whole is important to note. With regard to mortgages, that over 230,000 households in the FSC target market (4.5%) have obtained mortgages is an exceptional achievement in the true sense of the word – mortgages granted to exceptional households under a set of exceptional circumstances. If the costs of delivering a newly built unit remain at current levels, even a mortgage, the instrument which transforms a housing investment from an unaffordable lump sum into manageable cash flows, is unlikely to enable first time buyers (without equity) to cross the affordability barrier. Those who already own a mortgageable house may manage, but their sale depends on there being something affordable to buy. Unless significantly more affordable mortgageable housing products are created, those that are able to access the product in the future will, like their counterparts in the past, be the lucky few.

- ***A weak link between the availability of housing finance and the creation of new stock***

The discrepancy between the flow of funds to the FSC target market on the one hand and the very modest growth in affordable housing stock highlights the need to re-examine underlying hypotheses about the link between availability of funding and the creation of new stock, a principle motivation on the part of government to encourage bank provision of housing finance to the low income market. A R42 billion origination target seems, on the face of it, to be a significant injection capable in theory of funding the construction of around 200,000 units costing in the region of R200,000 apiece. However, BASA data indicates that less than R4 billion in developer loans was originated between 2004 and the end of Q3 2008, amounting to under 15% of the value of mortgage finance originated over the same period and less than 20,000 houses at

R200,000 per house. Clearly, new finance does not equal new housing: FSC loans have been used to finance transactions in the resale market as well. Given the shortage of stock to begin with this mismatch is likely to have been inflationary, ultimately eroding affordability for the many 'outsiders' at the same time as increasing the wealth of 'insiders'.

According to BASA data R8 billion was invested in housing by households in the FSC target market through PBLs and unsecured loans. While this has no doubt enhanced the value and variety of housing stock in the market, the products have limited scope for households that have yet to take the first step on the housing ladder.

The 2006 BASA sponsored study on Housing Supply and Functioning Markets highlighted significant non-finance related barriers to the creation of new stock, among them a lack of adequate bulk infrastructure. Arguably in the next round of target setting far more funding should be earmarked specifically for the provision of bulk infrastructure. In addition, alternative approaches to meeting the backlog including the release of newly serviced sites directly to aspirant homeowners should be explored. This would give greater scope for the range of funding instruments to support the creation of housing assets in line with the priorities and preferences of households in the target market.

- ***Distinguish between fundamental shifts in access and cyclical swings that impact on usage***

It is impossible to determine how much of the increase in usage of housing finance reflects the interest rate cycle and how much reflects more fundamental shifts in access. Of particular interest are changes in assessment criteria relating to the house as opposed to the household. The requirements of the NCA have limited degrees of freedom with respect to the latter. However, there are some indications that there is a closer alignment between lending criteria and the characteristics and location of housing stock in the target market. Once again, more data would enable this issue to be explored in more detail.

- ***Targets for targets sake***

While targets no doubt help to focus the collective mind there is the risk that they take on a life of their own. In some discussions the option of shifting income bands upwards has been proposed in light of the costs of newly built houses. While this would create a more easily achieved target it surely misses the point of the target in the first instance. Simply put, there is no access problem in higher income markets in South Africa. On the other hand if lending targets are significantly reduced there is no real point in bothering with any targets at all given their very limited potential impact relative to the market as a whole. At risk of restating the obvious, the challenge is to create functioning housing markets by enhancing access to housing finance for lower income households and not to meet somewhat arbitrarily crafted targets.

- ***So, where to from here***

The analysis has highlighted a number of critical areas where interventions may be fruitful in enhancing access to housing and housing finance for the target market including:

- The development of accessible and sufficiently attractive savings products to enable households to save for a deposit for a house (or for the purchase of land if this can be made available)
- The development of innovative and effective mechanisms to encourage greater participation in formal property markets by low income earners and first time homeowners (such as government subsidy beneficiaries)
- Closer alignment between end-user and development targets to ensure that end-user finance is not inflationary[41]
- Greater variability in housing products including serviced sites to enable households to access housing using a range of housing finance instruments

The analysis has highlighted shortcomings with respect to available data that could inform an assessment and highlight important constraints yet to be addressed. Critical questions relating to the performance of loans cannot be answered with available data. In this regard the Banking Association can play a critical role in facilitating the development and dissemination of valuable insights emanating from performance data while at the same time protecting the competitive nature of this information. This might include a comparison of application and acceptance rates, as well as loan performance across market segments and within the FSC target market to explore the impact of various product features (including fixed versus variable rates, deposits versus collateral guarantees, etc.). The analysis could identify geographic areas where problems that plagued low income mortgages in the past, most notably with respect to vacancy and sale, continue to do so. In addition, it can help to assess the impact of changes in lender requirements relating to the characteristics of mortgageable properties. Finally, looking forward, a rigorous review process can inform what additional data might be useful to systematically gather and

[41] The Housing Supply and Functioning Markets Study commissioned by the Banking Association of South Africa in 2006 highlighted various supply-side blockages including capacity at municipal level, long planning delays and significant constraints impacting on the provision of bulk infrastructure

monitor in the future to ensure that learning and sharing learnings are embedded in the process of enhancing access to housing finance.