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The effect of the National Credit Act, 2005 on home loans: a selected case in South Africa

Abstract

The National Credit Act, 2005 (NCA) was introduced by the South African government mainly to bring about accessibility to credit markets, protect consumers from malpractices and market abuses by credit providers and reduce consumer over-indebtedness. As a result, credit providers are compelled to apply stringent rules and regulations when assessing a credit consumer's affordability prior to granting home loans. The purpose of this paper is two-fold, firstly, to ascertain whether the NCA has prevented reckless lending by home loan providers, and secondly, to determine if the introduction of the NCA has prevented or reduced over-indebtedness amongst the home owners. The study applied a mixed methods approach using a sample of 250 respondents from the Pinetown Metropolitan area of KwaZulu-Natal, South Africa. The results of the research indicated that the performance of affordability and credit risk procedures by credit providers helped to ensure the prevention of reckless lending and also reduced over-indebtedness in the long-term.

Keywords: reckless lending, over-indebtedness, credit providers, National Credit Act, risks, home loans, South Africa.

JEL Classification: G21, G28, I20.

Introduction

In recent times, the global financial crisis has spread rapidly leaving the lives of millions in turmoil. The global financial crisis commenced in July 2007 when a loss of confidence by investors in the value of securitized mortgages in the United States resulted in a liquidity crisis (Fatalla, 2012, p. 3). The crisis really began to show its effect in the middle of 2007 and into 2008. Around the world, financial markets fell, due to poor lending practices, bad banking, and an over leverage of real estate that caused the economy to derail, resulting in foreclosures, bankruptcies and write offs as well as a global credit crunch (Sharma, 2011, p. 1). In addition to the challenge of operating a dysfunctional economy, the United States also faced another challenge known as housing affordability. According to Alabi (2014), a case study conducted in New York revealed that the poor households are utilizing more than 30% of their income on housing repayments and the burden of housing repayments affects the welfare of many households.

In South Africa, the poverty gap is considerable. Millions of South Africans live in poverty (Maki, 2009, p. 84). Therefore, the dream of many South Africans affording a home has become just that a "dream". Dubihlela and Dubihlela (2014, p. 165) recommend that the income criteria used to test affordability should be decreased to accommodate for poor households and effectively reduce the poverty gap associated with affordability of home loans. With soaring interest rates, it has become extremely difficult for home owners to make monthly repayments

on their home loan, thus leaving many South Africans destitute. In addition, relatively high housing prices have affected mortgage credit in the long-term (Lindner, 2014, p. 31). This, coupled with many other factors, such as elevated interest rates, increase in house prices and the easy access to credit, has severely damaged the mortgage market forcing the government to reassess the credit law in South Africa.

1. Context of the research

This research was undertaken in the Pinetown area. Pinetown is a city inland from Durban in KwaZulu-Natal, South Africa. The town is better known as situated in the Durban west Upper Highway area and is characterized as being a middle income district that is surrounded by two high income towns, namely, Westville and Hillcrest. Pinetown's fact file indicated that the town was established in the early 1850's and was used to house Boer women and children during the second Boer war. However, since the 1850's the city has embraced numerous social, economic and environmental changes which created a new transformed democratic town. The population mix in Pinetown consists of multi-racial groups of all ages belonging to different religions and faiths. The literature search in this study indicated that, not much research has been conducted in this area with regard to the NCA and its impact on the affordability of home loans. Therefore, the results of this research would contribute in determining if the NCA is sufficient to address the affordability of home loans in Pinetown and incidentally ascertaining the impact the NCA has on affordability of home loans.

2. Literature review

Fu (2007, p.1) stated that many Australians are enduring the housing affordability crisis. According to Sliogeris, Crabtree, Phibbs, and Johnston (2008), Australia has experienced increasing problems in

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housing affordability and problems extend from extremely low income groupings to moderate income households. Australia's affordability criteria are benchmarked to the 30/40 rule, which implies 30% or at least 40% of income distribution is allocated to housing cost. Beyond this rule, housing is considered to be unaffordable. Berry (2006, p. 28) noted that the declining rate of affordability in Australia has been fuelled by the escalating housing prices which are at the forefront of income coupled with elevated interest rates and the increasing housing boom which also increases housing stress. Fu (2007, p. 70) added that housing affordability in Australia necessitates the attention for further researchers and policy makers to investigate, maintain and develop alternatives to address this problem.

According to Angel (2000, p. 6), in developing countries like Brazil, the growth and allocation of incomes affect the housing market and a developed banking sector affects accessibility for mortgage financing. In addition, restrictions to accessible mortgage finance may occur due to extremely elevated inflation and interest rates. Sundgren (2003, p. 9) stated that, in order to enhance the housing market, the government aims at achieving the following objectives: development of healthy housing finance sector; improve housing conditions; make ownership more affordable; and ensure that credit is distributed according to social objectives.

The mortgage finance sector in Kenya, compared to previous years, is well developed and provides much competition and innovation, but, unfortunately, this sector provides for specifically high income households. The challenge in the mortgage finance sector is to initiate ways of providing access for finance to low income groupings (Mutero, 2007, p. 3). Kenya's housing market includes a new expansion called Individual Housing Development which allows individuals to develop their own house through land purchase. According to Kamau (2002, p. 36), the immense demand for housing in Kenya is relatively high and the development of additional housing for all income groups is inadequate. Karley (2009) added that, in developing countries, there are high levels of housing affordability due to escalating housing costs. This brings about additional obstacles in the Kenyan housing market.

The South African financial sector has experienced numerous changes over the past two decades and this sentiment is also echoed by Peters (2009). Prior to 1994, the apartheid government implemented and supported many financial policies within the financial sector that resulted in inefficiencies and the greater population of South Africa was restricted legal access to formal credit. The effect of these policies brought about limited market competitive-

ness and was of benefit to only a small number of South Africans (Kirsten, 2006, p. 2). The South African housing system remained in chaos due to defaults on home loans granted by commercial banks (Pillay and Naude, 2006, p. 79). Variable interest rates governed the residential mortgage market and low income earners remained victims of home loan default, due to lack of default literacy (Mkukwana, 2012, p. 13). Post 1994, the democratic government introduced many policies and strategies to aid economic growth and to provide support in many aspects by implementing appropriate monetary policies; housing policies; reconstruction; development programmes and the growth; and employment and redistribution policy. These policies were executed to uplift the lives of many previously disadvantaged citizens. As a result, South Africans were able to enjoy the benefits of consumer spending as interest rates were reduced significantly.

Van Heerden (2008, p. 57) conducted an investigation on the effect of the NCA on the future of specialized micro-lending institutions in South Africa. His findings revealed that the NCA would compel some micro lenders to cease their business and cause a shift for both small and medium-sized lenders to a larger category of micro lenders in order to operate efficiently with sufficient volumes. Van Heerden (2008) further added that the migration of the small and medium to the larger-sized category lenders will alter the structure of the industry, ultimately increasing competition within the industry and forcing change, irrespective of the size of the micro lender.

According to Pieterse (2009, p. 157), the impact of the NCA on the motor industry has created more complexity in obtaining vehicle finance. In addition to the NCA, other costs such as living cost and motor vehicle retail prices are the factors that limit the amount of motor finance granted within the South African motor industry. Coetzee (2009, p. 24) added that the NCA has also impacted on the legal proceedings that apply to debt enforcement, indicating that both debt review and debt enforcement procedures cannot be carried out simultaneously and that credit providers must exercise compliance with the NCA with regard to debt enforcement.

2.1. Regulatory framework. Prior to the NCA coming into effect in South Africa, the credit market was controlled by the Usury Acts and their Exemption Notices. The NCA was the government's attempt to keep the credit market regulated. However, due to rapid changes over time in the market, there has been a constant need to review and amend credit legislation.

The National Credit Act No. 34 of 2005 was promulgated on 1 June 2007 to create a more stable credit

market and is applicable to all credit transactions. One of the main aims of the Act is to protect consumers from becoming over-indebted by providing stringent rules, taking into consideration net disposable income in determining affordability and preventing credit providers from lending money recklessly to consumers. According to Pillay (2009, p. 1), since the promulgation of the NCA, the residential property market has slackened due to increasing economic conditions and high interest rates. Commercial banks have also been sanctioned from freely granting home loans, making it more difficult for consumers to purchase a home.

According to Van Heerden (2008, p. 28) the National Credit Act (NCA) of 2005 is a unique piece of legislation in that it is represented as a legally binding document, allowing for all credit transactions to be administered and regulated by a single Act. The NCA was introduced to protect consumers and principally address consumer credit problems. The Act benefited consumers by providing the necessary knowledge to assist consumers in managing their debt and understanding the consequences of payment defaults, prior to entering into a credit agreement. In addition to the benefits, the Act makes certain that all related transactions are transparent, fair and simple to understand and provides the consumer the right to enquire and obtain further clarity of information as required (Pillay, 2009, p. 2).

The NCA further protects consumers from exploitation by financial institutions and prevents consumers from getting into credit agreements that are not in their best interests. It intends to ensure that credit providers do not take advantage of consumers through their status of over-indebtedness and reckless lending, and provides additional clarity on payment defaults on consumer accounts and the basis of default collection (Rossouw, 2008, p. 2).

The implementation of the National Credit Act (NCA) has affected the South African property industry. Most importantly, the Act has altered the way in which credit providers conduct their business. Credit providers are to comply with the regulation when granting home loans and utilize an appropriate method of determining the housing affordability of a consumer applying for a home loan.

2.2. Prevention of reckless lending. Prior to the introduction of the NCA, South Africa's Ombudsman for Banking Services faced an increase in complaints from consumers who were in financial distress after responding to unsolicited offers of credit from the country's major banks (Mahlangu, 2007). Other consumers complained that credit providers were increasing borrowers' credit limits without consulting the consumers. The NCA was enacted to

reduce reckless lending. According to the NCA, a credit agreement will be deemed to have been entered into recklessly if the credit provider failed to conduct the required assessment, or having conducted it, enters into an agreement with a consumer despite the fact that the consumer did not appreciate the nature of the risks, costs and obligations, or could not afford them (Stoop and Louw, 2011, p. 20).

Some lenders have speculated that the NCA will not only stop reckless lending to individuals who cannot afford it, but will also delay loan approvals, as more stringent requirements must be adhered to (Lund, 2014, p. 1). According to Vessio (2009, p. 274), reckless lending is a new concept in South Africa and prohibits credit providers from granting credit recklessly to consumers. Before the NCA took effect, many credit providers granted credit to borrowers without conducting the necessary credit checks and assessments, which are significant in determining the borrower's credit worthiness.

Credit providers will have to be wary of the way in which they conduct their business and also avoid entering into credit agreements that could lead them to become reckless lenders and, therefore, endure legislative consequences. In addition, credit providers are to assess what a credit consumer can afford by utilizing an appropriate method of assessment, prior to granting credit (Scott, 2008, p. 16). The NCA has given a great deal of attention to reckless lending and has dedicated Section 81 of the Act to define and classify the types of reckless lending. The Act also cautions credit providers about the consequences of entering into credit agreements with consumers recklessly. The consequences are prescribed in the Act itself and can also be determined by the courts (Boraine and Van Heerden, 2010, p. 650).

Stoop and Louw (2011, p. 2) reported in conjunction with the provisions stipulated in the NCA regarding reckless lending that credit providers should not enter into credit agreements without properly assessing the consumer's understanding of the risks and the cost of the proposed credit and his rights and obligations under the proposed agreement. The credit provider must also take into account the consumer's debt repayment history, existing and current financial means, prospects and obligations. In return, the consumer must provide complete and honest information that is required by the credit provider as part of his/her assessment. When a credit agreement is declared reckless, the credit providers that are found guilty may suffer the consequences determined by the court. The NCA does, however, offer the credit provider an opportunity to defend the allegation (Renke, 2011, p. 208).

2.3. Over-indebtedness consumer reduction. The NCA aims to curb over-indebtedness of the South African credit consumers. The Act requires that the credit provider must conduct a proper assessment of each consumer's ability to meet obligations by taking reasonable steps to investigate and evaluate the consumer's understanding and appreciation of the risks, costs and obligations of the proposed agreement. According to Prinsloo (2002, p. 62), the ratio of debt to income levels in South Africa is too high, and continues to increase even after the implementation of the NCA.

Mlandu (2007, p. 13) argued that the easy access to credit has led to the elevated levels of over-indebtedness. In terms of the Act, a consumer may be considered as over-indebted, if most of the information on hand at the time the determination is made indicates that the consumer is unable to satisfy all the obligations under the credit agreement timely. This involves considering the consumer's (a) financial means, prospects and obligations 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 payment. Vessio (2009, p. 276) pointed out that the concept of over-indebtedness, which is defined within the Act, is quite theoretical and that the courts will have to interpret the wording into practical implementation by utilizing foreign examples and local statistical indicators when assessing a particular consumer's over-indebtedness, as globally there is no recognized definition of over-indebtedness.

3. Research methodology

3.1. Research design. The proposed research employed a mixed methods approach and was selected because this type of research method is useful in describing the characteristic of a large population with considerable flexibility given to the analysis of the survey. The mixed methods approach brought about a better understanding of the study under investigation as the research consisted of both quantitative and qualitative research techniques (Creswell and Plano Clark, 2007, p. 5). The researcher utilized a combination of both quantitative and qualitative research techniques to conduct a survey. This study is cross-sectional in nature.

3.2. Population and sample. The population for the proposed study comprised of home loan borrowers in the Pinetown area, who have acquired home loans between 2009 and 2013. A sample size of 250 respondents in the Pinetown area was

used for the proposed study. The convenience sampling technique was utilized to select a sample for administering questionnaires. Convenience sampling method allowed respondents to complete questionnaires at their convenience and availability. The convenience sampling method involves selecting a desired group of people that meet the criteria of one's total target population (Davis, Gallardo and Lachlan, 2012, p. 165). In this study 250 questionnaires were administered to home loan borrowers in Pinetown and 190 questionnaires were returned, resulting in a 76% response rate.

3.3. Data collection. Participants were approached by the researcher at the Knowles Spar in Pinetown for the duration of three weekends. The researcher provided clear explanations to them about the aims and purpose of the study. Participants were requested to indicate their willingness to participate in the study and complete a questionnaire. The questionnaire was divided into sections assessing various aspects on the impact of the NCA on affordability of home loans. The questionnaire comprised of closed questions, a Likert scale and open-ended questions.

3.4. Validity and reliability. In order to minimize the influence of prior expectations and opinions that the researcher may have had in the analysis process, multiple and varying perspectives on the impact of the NCA were obtained. These perspectives ranged from varied experiences of home loan borrowers. The researcher ensured reliability by designing a measuring instrument, which provided results that were as reliable as possible (Babbie, 2013, p. 192) and increased validity by utilizing a mixed methods approach. Measurement validity relates to the extent the measuring instrument measures what it is meant to measure. The measurement becomes valid once it represents the concept or object it claims to measure.

The two most important aspects of precision are reliability and validity. Reliability is computed by taking several measurements on the same subjects. A reliability coefficient of 0.70 or higher is considered as "acceptable" (Nunnally, 1978).

Table 1 below reflects the Cronbach's alpha score for all of the ordinal items that constituted the questionnaire.

Table 1. Cronbach's alpha validity

Score case processing summary		
	N	%
Valid	174	91.6
Cases Excluded	16	8.4
Total	190	100.0

Table 1 indicates the validity score of 91.6% obtained for this study. Table 2 illustrates the reliability score for the study.

Table 2. Cronbach's alpha reliability score

Reliability statistics	
	N of Items
.890	14

The overall reliability score of 0.890 satisfies the minimum recommended value of 0.70. This indicates a high (overall) degree of acceptable, consistent scoring for this research.

4. Findings

The concepts reckless lending and over-indebtedness cannot be viewed in isolation as there appears to be a positive correlation between the two variables. An increase in reckless lending will most certainly bring about an increase in over-indebtedness and vice versa. The research objectives: preventing reckless lending and reducing over-indebtedness were addressed by assessing if credit risk and affordability procedures were conducted prior to the granting of home loans in the Pinetown (Table 3).

Table 3. Scoring patterns for credit risk and affordability procedures

	Agree	Unsure	Disagree
A home loan pre-qualification process assisted me in determining what is within my affordability	81.91	13.83	4.26
My home loan affordability was calculated measuring my net disposable income to my household expenses	85.11	12.23	2.66
Prior to approving my home loan, my credit provider obtained a valuation assessment of the market value of the property	82.26	12.37	5.38
I was offered the best interest rate by my credit provider	66.84	19.25	13.90
My credit provider obtained my consent before contacting the credit bureau	74.33	18.18	7.49
In my opinion, my credit scoring was conducted appropriately	72.73	20.86	6.42
I am aware of the documentation verification process, which is in compliance with the Financial Intelligence Centre Act (FICA)	76.19	18.52	5.29

The highest levels of agreement are the following statements which fall under assessing credit risk and affordability:

- ◆ Prior to approving my home loan, my credit provider obtained a valuation assessment of the market value of the property;
- ◆ My home loan affordability was calculated measuring my net disposable income to my household expenses; and
- ◆ A home loan pre-qualification process assisted me in determining what is within my affordability.

Table 3 provides a clear indication of the procedures that relate to assessing credit risk and affordability. According to Zhao (2003, p. 11), financial institutions employ a dynamic set of criteria to assess a borrower's creditworthiness before granting credit to the borrower. A method of credit scoring is usually utilized and is a fundamental part of the assessment process (Van Vuuren, 2011, p. 18). Another step within the assessment process is known as a pre-qualification process. In this study, a large portion of respondents (82%) agreed that a *pre-qualification process* assisted home loan borrowers in determining what is within their affordability and a small portion (18%) aggregate were unsure and disagreed. This means that majority of the home loan borrowers had conducted a pre-qualification process, which guided them on the amount that is within their means before applying for a home loan.

The majority of respondents (85%) were in agreement that their *affordability was calculated measuring their net disposal income to their household expenses*, with only (12%) unsure and (4%) disagreed. Assessing a borrower's affordability entails measuring disposal income to household expenses (Kutty, 2005, p. 113). Credit providers must consider household expenses when evaluating affordability as housing absorbs a considerable portion of household expenditure (Yates, 2006, p. 1). The high agreement of (85%) strongly suggests that credit providers are complying with the NCA in conducting appropriate affordability and determining a borrower's credit worthiness prior to granting of a home loan. Performing affordability assessments is a critical step in the home loan process. It helps to eliminate reckless lending and also reduces consumer over-indebtedness.

A significant percentage (82%) of respondents agreed that *credit providers obtained a valuation assessment of the market value of their property prior to approving their home loans*. A small portion of respondent (12%) revealed they were unsure and (5%) disagreed that a valuation assessment was conducted on the market value of their property. Affordability is greatly influenced by increases in housing prices (Wirtz, 2005, p. 6). Therefore, prior to approving a home loan, credit providers must obtain a valuation assessment of the market value of the property to ensure that the value is within the borrower's means and monthly repayments can be

met. This implies that increasing housing prices is a major contributing factor that affects a home loan borrower's affordability. Increasing house prices will require an increase in a home loan borrower's household income to enable the borrower to afford the home loan.

According to Angel (2000, p. 6), soaring interest rates restrict access to credit and also affects affordability. Since the enactment of the NCA, the period 2008-2009 demonstrated elevated levels of interest rates. However, until 2013, the interest rate has been scaling from 8.5% to 9% (OECD, 2013, p. 4). In this study, (19%) of respondents indicated they were unsure and (14%) disagreed that *credit providers had offered them the best interest rate*. However, (67%) confirmed their agreement. Just over two thirds of respondents indicated that they received the best interest rate. This suggests that interest rates contributes largely in determining if a home loan borrower can afford a home loan over the agreed long-term period of the loan.

Despite the (74%) agreement that *credit providers obtained the consent of the home loan borrowers before contacting the credit bureau*, (18%) of respondents were unsure and (7%) disagreed. Most home loan borrowers (73%) agreed that their *credit scoring was conducted appropriately*, whilst (21%) were unsure and (6%) disagreed. According to McNab and Wynn (2004, p. 13), credit scoring is an essential tool used in the credit assessment process. The process involves examining the borrower's credit records and formulating a decision as to the ability to make repayments (Crook, Edelman and Thomas, 2007, p. 1463). This implies that credit providers did assess the home loan borrowers' credit history in order to confirm or make informed decisions as to whether the borrowers are creditworthy and if there is a possibility for the borrower to default on his/her home loan. In addition, the credit scoring process would have guided credit providers in making decisions on potential default borrowers. These credit records, credit providers are able to make informed predictions as to future risk of payment default, which will eventually give rise to mortgage credit risk.

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Most respondents (76%) confirmed their *awareness of the document verification process*. A significant portion of almost (20%) of respondents indicated a level of uncertainty and (5%) disagreed. Included in the credit assessment process is a procedure that involves the verification of documents. South Africa has a Financial Intelligence Centre (FICA), governed by FICA, 2001 Act. Respondents indicated their awareness to the Act. According to De Koeker (2002, p. 22), the Act was established to fight against money laundering activities and to enable financial institutions to identify their clients.

Conclusion

The statements that relate to credit risk and affordability procedures have a high response rate of agreement. This means that credit providers did conduct credit risk and affordability assessments to determine the home loan affordability of borrowers. The outcome of these assessments would indicate to credit providers the loan amount that would be applicable for each home loan borrower. In addition to the credit risk assessment and affordability procedures conducted, home loan borrowers in Pinetown also submitted documentation for the FICA compliance process. Overall, the findings in this section have indicated that credit providers have prevented reckless lending and reduced over-indebtedness in the long-term by conducting the necessary credit assessments prior to the granting of home loans in Pinetown.

Recommendations

- ◆ Potential home loan borrowers ensure that credit providers conduct proper affordability and credit risk assessments prior to the granting of home loans. These assessments are vital in evaluating the affordability and creditworthiness of a home loan borrower.
- ◆ Borrowers need to be aware of the consequence of credit providers not conducting appropriate affordability and credit risk assessments and also understand the impact this will have on them financially.

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