

**UNSECURED LENDING HAS CONSUMERS
SLIDING TOWARDS FINANCIAL RUIN -
HOW DO WE REVERSE COURSE?**

27 August 2019





THOUGHT LAB

WHAT IS DIFFERENTIAL'S "THOUGHT LAB"?

Part of being an investment manager in South Africa is voicing opinions on societal issues as they relate to ESG. It is not a role we take lightly or for granted. Our intention is to leverage our position as custodians of capital to be positive societal agents of change. Our "Thought Lab" offerings are reports that we hope engage and challenge our readership to offer comments, discussion, and constructive disputation on our views. We are optimistic that this forum will allow us to engage key stakeholders, particularly policymakers, to further the debate and drive change in the pursuit of a better South Africa for all.

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EXECUTIVE SUMMARY



The unrestricted power of unsecured lenders is burying lower classes into the same inescapable poverty they've been fighting for generations

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Proliferation of large, long and expensive loans is the unintended consequence of well-meaning regulation. Embraced as a paradigm shift that would empower previously disadvantaged individuals by promoting financial inclusion, unsecured lending has instead primarily caught the young and less affluent among us in debt traps. It is a dysfunctional industry where lenders compete on the largest loan size, not on customer value, preying on financial illiteracy and consumer demand for credit. Aggressive collection practices and extortionate pricing have ensured that even though around one-half of all unsecured lending consumers are in default, the lending industry remains highly profitable. There is a misconception that irresponsible unsecured lending or microcredit is the preoccupation of only illegal *mashonisas*¹ or small-scale regional lenders who defy the law. However, our

research shows that reckless lending is almost systemic to the industry, except for the “Big Four”² banks.

We accept the need for financial inclusion. However, we contest that high-cost loans (specifically short-term loans) are detrimental to this endeavour.

The risks to society are clear, and the most abhorrent manifestation of this was the Marikana tragedy on 16 August 2012. Numerous studies provide clear evidence that unsecured loans placed miners under substantial financial strain. We submit that consumers and the country would be better served by drastically amending the legislation to ensure a more sustainable lending industry, and one that accomplishes the stated purpose of the National Credit Act (NCA), namely, “to promote and advance the social and economic welfare of South Africans”.

¹ Loosely translated to mean “cause to become poor”

² Absa, Firststrand, Nedbank, Standard Bank



THE OPPOSITE OF FINANCIAL INCLUSION

- Egregious all-in cost - as high as 225% p.a.
- Endemic to society - 7.8m consumers owe c.R225bn in unsecured loans (c.R29 000 per consumer)
- Unproductive credit – proceeds primarily used for consumption (at least c.75%)

DEBT TRAP & POVERTY CREATION MECHANISMS

- High repeat business rate
- Disbursements fund c.66% of repayments
- Less than 10% of consumers with an unsecured loan have a mortgage or VAF
- 3.2m (40%) consumers are in arrears



LEAST AFFLUENT & YOUNGEST CREDIT-ACTIVE CONSUMERS

- c.50% younger than 40
- c.36% earn < R5 000 p.m, c.81% earn < R15 000 p.m.
- Pay c.33% of net income, on average, to service their unsecured loan
- Consumer numbers declining, but book is growing – consumers owe, on average, almost 50% more than they did four years ago
- Average borrower has 1,7 unsecured loans
- c.66% of new-to-credit consumers receiving an unsecured loan earn < R5 000 per month
- Government employees (1.1m, c.85% penetration) owe c.R75bn (c.R67 000 each)
- Social grant recipients also targeted



DYSFUNCTIONAL LENDERS - but not all are the same

- Compete on risk (size), not value (cost)
- Non-bank lenders dominate low-income, payday lending (c.94% market share) – the most damaging segment of the market
- Sector mired in controversy
- Bank lenders are not homogenous – wide spectrum of risk tolerance, with “Big Four” being the least risk-seeking



ENTRENCHES INEQUALITY & POPULISM

- Marikana a clear warning of the severity of the problem
- Today’s frivolous consumption is borrowed from tomorrow’s productive investment
- Wealth transfer from poor to rich

REQUIRES AN OVERHAUL TO LEGISLATION



INTRODUCTION

Before the promulgation of the National Credit Act (NCA) of 2005, unsecured loans fell under the ambit of the Usury Act. This Act restricted the loan sizes to R6 000 (R10 000 from 2019) and the terms for repayment to 36 months. Under Apartheid, black South Africans were primarily excluded from the financial system, and the Usury Act exemption was intended to address this. Importantly, the interest rate was not restricted, leading to many abuses. These included 'outrageous' interest rates of up to 30% per month, access to Persal (direct deductions at source for public sector employees), 'garnishee orders' and confiscation of bank cards and personal identification numbers (PINs) among others. In February 2000, the parliamentary working group commented that "clearly a more effective regulatory system is needed with an interest rate ceiling, under conditions which would nevertheless not scare micro-lenders back underground but rather encourage competitiveness, and as a result better interest rates and a more tightly controlled system" (PMG, 2000).

A year earlier, registration with the Micro Finance Regulatory Council was required for any lender conducting business under the exemption. This was, ostensibly, to curtail abuses within the industry. In 2000, government restricted access to Persal, ending the repayment of loans at the source. Lenders buckled under the strain of defaults due to this change. Deducting before the consumer received their salary meant that traditional metrics assessing the ability to pay were likely ignored. This was evidenced in the collapse of UniFer in January 2002 closely followed by Saambou Bank, which was placed into curatorship one month later. The latter required a bailout of R7 billion – paid by South African taxpayers.

The crisis precipitated the promulgation of the National Credit Act of 2007. This new legislation abolished the term and size limit on unsecured loans. It also prescribed maximum limits on interest rates, service and initiation fees charged.





However, **lenders were creative in terms of bolting on products to the loan (such as credit life insurance, membership fees, income protection policies, etc), which neutered the regulator's restrictions.**

The National Credit Amendment Act 19 of 2014 intended to prescribe clear guidelines for credit providers in estimating client affordability. This, in our view, was a tacit admission that credit granting was reckless and needed to be addressed. On 9 February 2017, the Credit Life Insurance Regulations were published. This limited the amount charged per R1 000 of cover to R4.50 (King, 2017). This is important because the bolt-on products, particularly credit-life insurance, were used as mechanisms to circumvent the limits on interest rates and fees (PMG, 2016).

Unsecured lending has become pervasive among credit-active consumers in South Africa. What was once the purvey of specialist niche microlenders and illegal mashonisas has now become mainstream lending in South Africa. The large banks entered the fold and the new model allowed once-small bank Capitec to become mainstream. It also created an existential crisis for African Bank as it was forced to compete with providers with a competitive advantage in the form of transaction banking. This ultimately contributed to its failure in 2014.

The self-stated purpose of the NCA is:

- 1. "to promote and advance the social and economic welfare of South Africans"***
- 2. "promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry and"***
- 3. "to protect consumers while balancing the rights of suppliers"***

In this report, we examine the evidence, specifically with regards to unsecured lending, critically assessing whether the NCA has been successful in its stated aims. While the endeavour to expand financial inclusion is a noble one, we analyse what the unintended consequences may have been. We consider if amending the regulation would better achieve the ambitions of the policymakers and result in greater social utility.

BACKGROUND



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To understand the potential hardship that unsecured lending poses, it is important to first understand the features and evolution of the product.



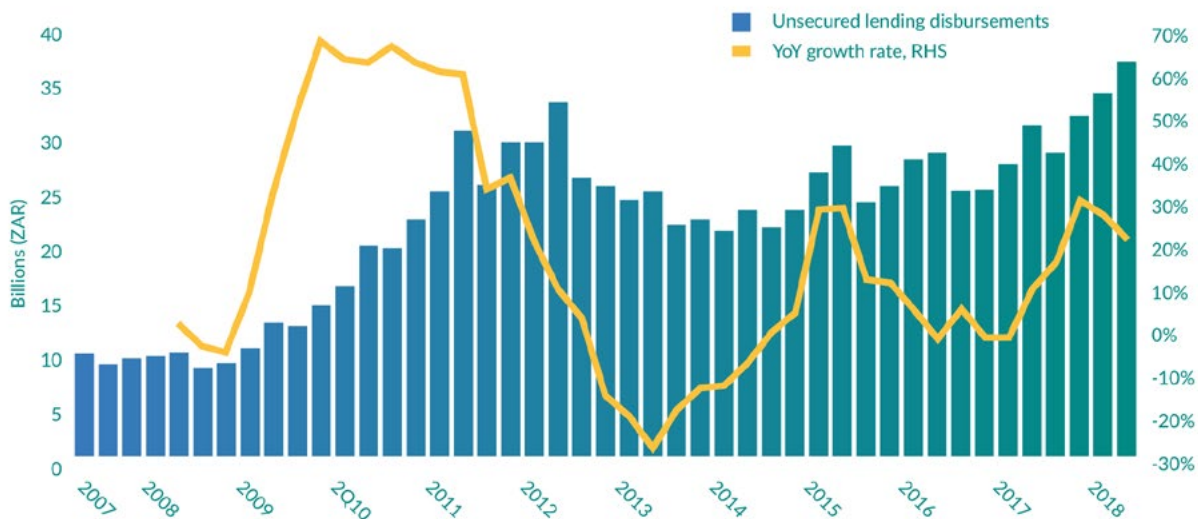
In South Africa, unsecured loans are marketed as products enabling consumers to live better lives.

These loans are marketed for everything - from holidays, education, home improvements and cars to emergency needs, funerals and more. The unifying theme within the marketing of these products is that

it enables one to 'get ahead' in life or overcome an apparent urgent financial need.

The marketing has been effective. Unsecured lending now accounts for 25% of all new retail credit disbursed legally.

Figure 1: Unsecured lending has grown in nominal terms from R34bn of sales per year in 2008 to R116bn today

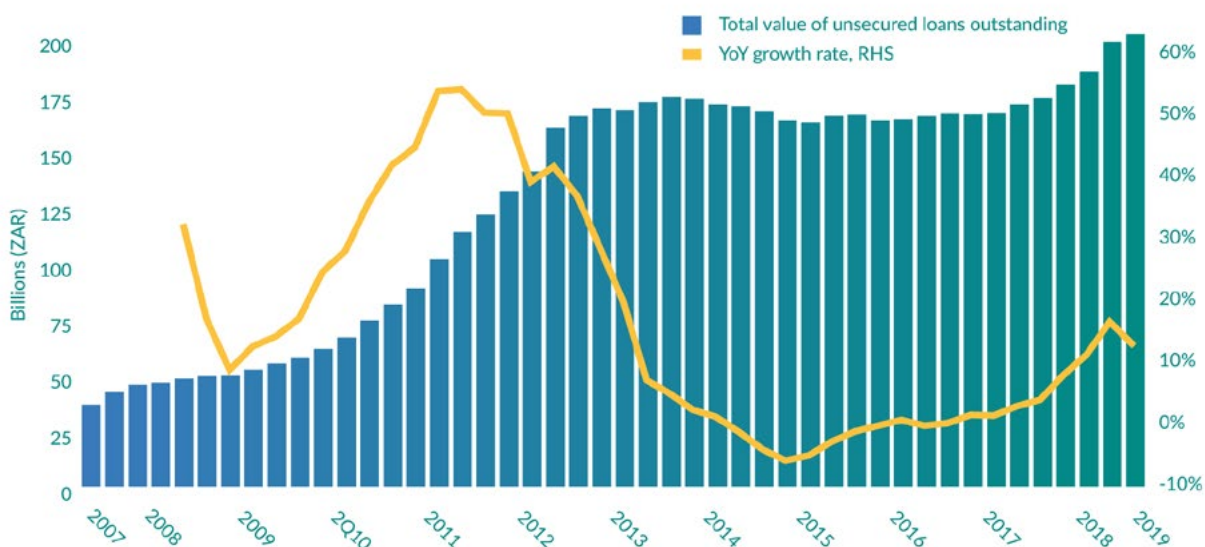


Source: NCR CCMR, Differential Capital estimates

South African credit-active consumers now owe c.225bn in unsecured loans⁴. The value of unsecured loans outstanding has unsurprisingly grown dramatically since the introduction of the NCA.

Following a short reprieve after the failure of African Bank, and the introduction of affordability assessments in 2016, it is enjoying something of a resurgence now.

Figure 2: Growth of unsecured lending was explosive leading up to the failure of African Bank. Growth rates have started trending up

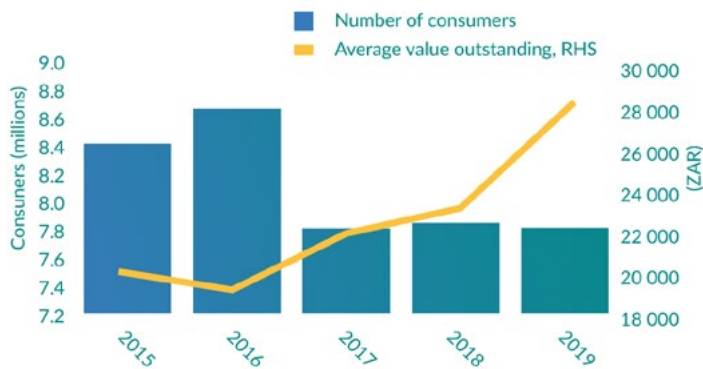


Source: NCR CCMR, Differential Capital estimates

⁴ This figure is based on credit bureau data which is more recent and accurate than NCR data. We have favoured credit bureau data over NCR data wherever possible

Alarming though, the number of consumers with an unsecured loan has decreased substantially since 2015. This means that the remaining consumers have larger balances outstanding.

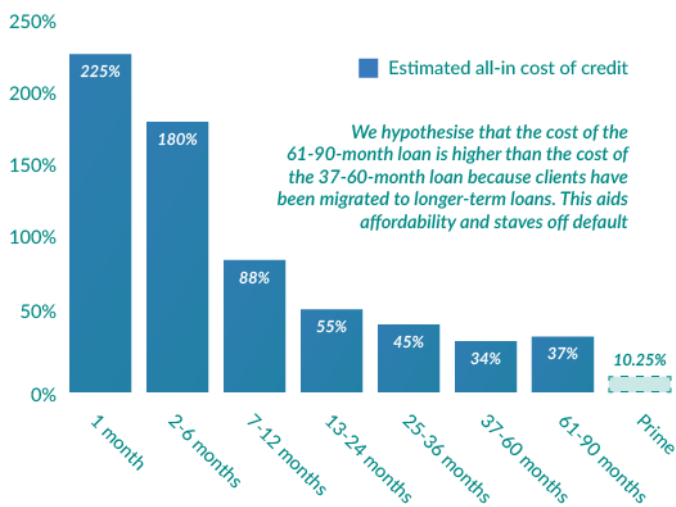
Figure 3: The number of consumers with an unsecured loan has declined since the institution of affordability assessments and has been flat for three years. However, average balances have risen by c.45% over the same period



Source: XDS credit data - accessed through Eighty20 portal, NCR CCMR, Differential Capital estimates

While these loans may be touted as constructive credit, the reality is somewhat different. **Unsecured loans have costs which many would consider egregious.** Until the imposition of caps on credit life in February 2017, the NCA only regulated the interest rate, initiation fees and services fees. Loans were, and still are, bundled with add-on products such as credit-life insurance and membership fees. For the lender, it does not matter if the return is earned from regulated or unregulated streams. The Department of Trade and Industry (DTI) has capped credit-life insurance and attempted to solve the add-on product phenomenon, although all-in costs remain high relative to other forms of credit. Our best estimate of the all-in, annualised, industry-wide cost of credit by tenure is shown in Figure 4.

Figure 4: Estimated annualised all-in cost of credit is extremely high across all debt maturities

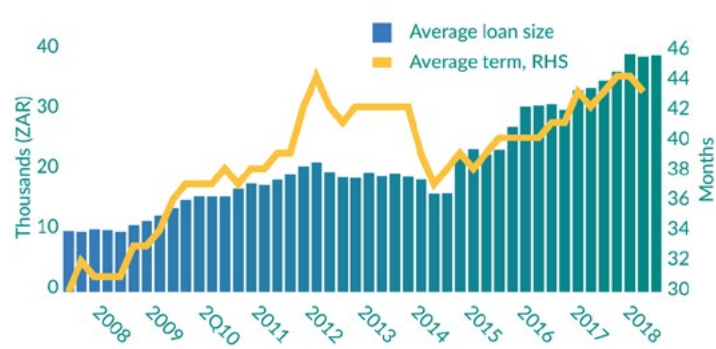


Source: XDS credit data, NCR CCMR, various providers' websites, mystery shopping, SARB, Differential Capital estimates

We argue that the all-in cost of credit is egregious by any measure. A person in need of a one-month loan is not likely to be able to pay an annualised yield of 225% without likely needing further loans, thus ensnaring them a debt trap.

Our research indicates that South African consumers are credit hungry and shop for 'bang for buck'. **Consumers are not preoccupied with the cost of credit, but rather the size of the loan.** The consumer prefers to pay off a loan over several months as this enables them to get a larger loan. Lenders are accommodating to all but the worst risk of clients (with risk in this context being relative). This drives the industry to riskier and longer-term loans.

Figure 5: The average term of new disbursements has increased to c.43 months today from c.30 months in 2007. The average loan size has increased to c.R35 000 from c.R9 000 over the same period.

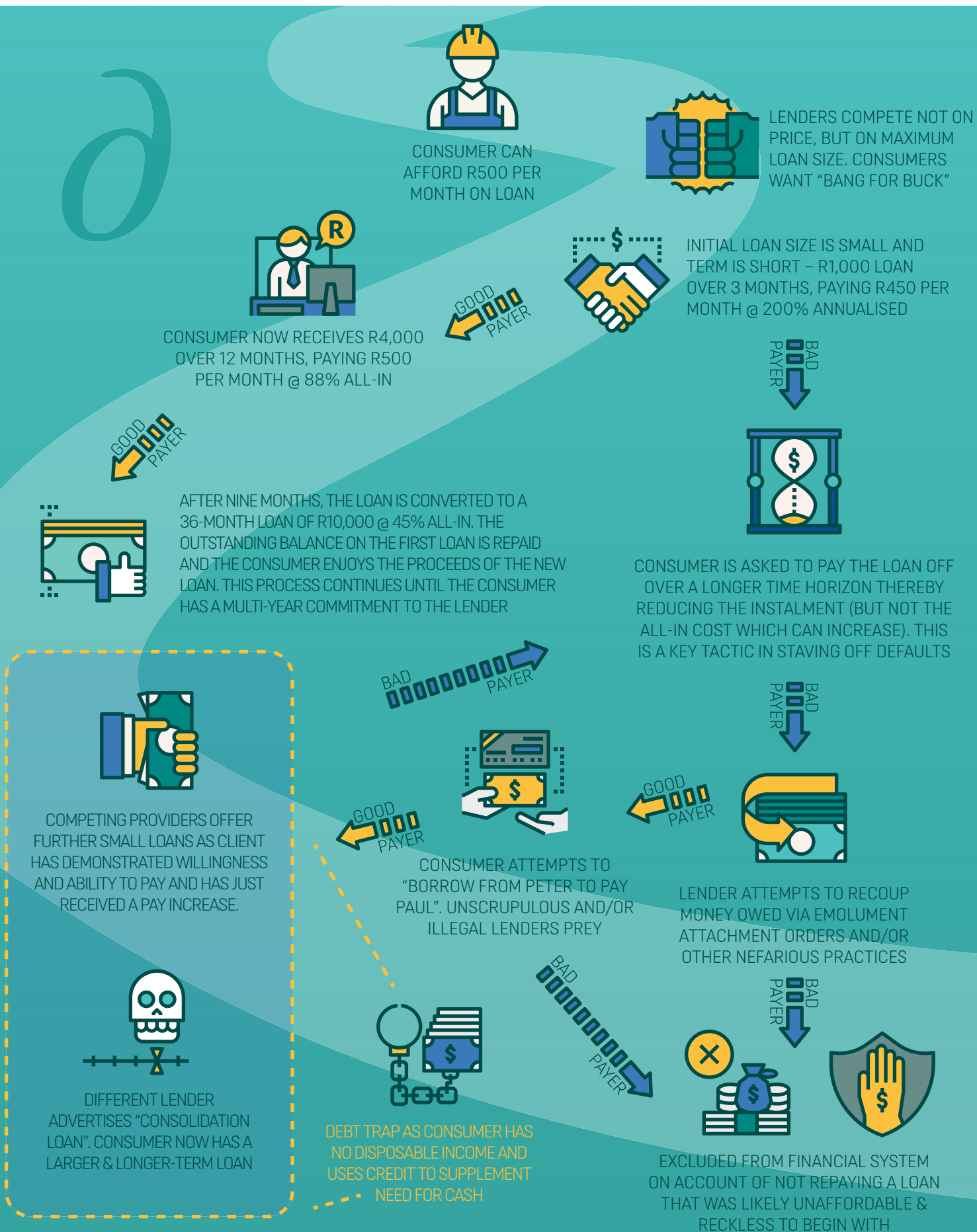


Source: NCR CCMR, Differential Capital estimates

Term extension is used to lock in clients. A lender risks losing a client to a competitor that is willing to grant a larger loan over a longer period. Our research indicates that this longer term is also used to enable

affordability, and most concerningly, to avoid default.

The schematic that follows shows the typical lifecycle of a consumer with an unsecured loan:



Perhaps the debt trap that consumers almost invariably find themselves in after taking out an unsecured loan would be more palatable if its proceeds were used for constructive purposes. After all, the original intention of financial inclusion would be for the purposes of uplifting the previously excluded.

This **upliftment is only possible if the returns generated on the loan through constructive means is greater than the interest on the loan**. As an example, if the borrower were to use the loan proceeds to fund a business, he will become poorer if the return on the investment is lower than the cost of the loan. Unsecured lending at egregious costs, used primarily for consumption purposes only makes the borrower poorer.

The concept of microfinance was born through Professor Muhammad Yunus's experiment in Bangladesh in the early 1970s. Professor Yunus won a Nobel Prize in 2006 for his idea that informal microenterprises and self-employment are conducive to ending widespread poverty. Microcredit, at its inception, was lauded as an ingenious solution to poverty. Providing small loans to the poor was meant to empower them to escape poverty (Bateman and Chang, 2012).

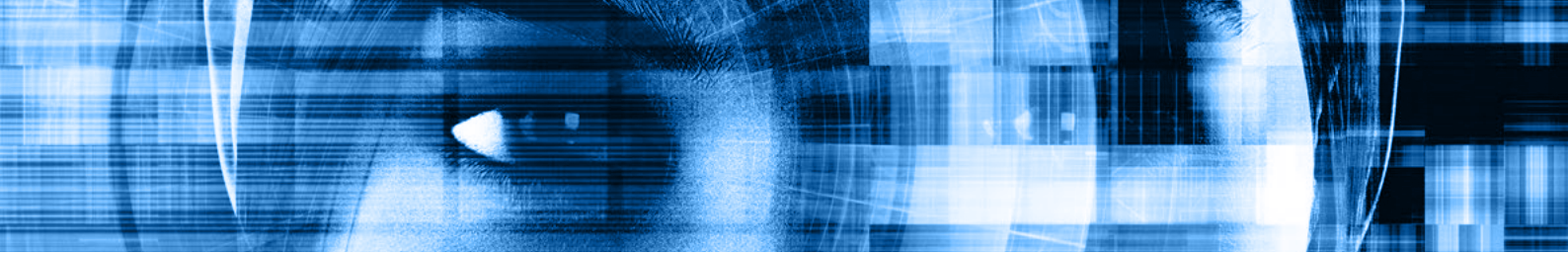
Figure 6: South African unsecured loans, due to the costs and size, lead to outcomes that differ from the intentions of inclusive microcredit.

MICROCREDIT	SA UNSECURED LOANS
Small loans	Large loans
Short-term loans	Long-term loans
Granted to unemployed people	Targeted exclusively at employed people
Intended for creation of income-generating activities	Marketed & used for consumption purposes
Low cost	Exorbitant costs
Developmental focus	Profit motive

Source: Differential Capital Research

Unfortunately, the translation of microcredit into the South African economy bears little resemblance to its original format or intent.

Academics dispute the effectiveness of microcredit, even the supposedly good kind. Muhammad Yunus has had to defend the model of microfinance, with critics saying it causes debt traps for those it is meant to help. In a scathing indictment on the concept of microfinance, Bateman & Chang (2012) state *“the concept of microfinance was the international development community’s highest-profile and most generously funded poverty reduction policy. Neoclassical economic theorists and neoliberal policymakers both fully concurred with the microfinance model’s celebration of self-help and the individual entrepreneur, and its implicit antipathy to any form of state intervention. The immense feel-good appeal of microfinance is essentially based on the widespread assumption that simply ‘reaching the poor’ with a tiny microcredit will automatically establish a sustainable economic and social development trajectory, a trajectory animated by the poor themselves acting as micro-entrepreneurs getting involving in tiny income generating activities. We reject this view, however. We argue that while the microfinance model may well generate some narrow positive short run outcomes for a few lucky individuals, these positive outcomes are very limited in number and anyway swamped by much wider longer run downsides and opportunity costs at the community and national level. Our view is that microfinance constitutes a powerful institutional and political barrier to sustainable economic and social development, and so also to poverty reduction”* (Bateman and Chang, 2012). Bateman then wrote several books where he questioned the conventional wisdom and attempted to change the zeitgeist around the endeavour.



Further studies into microfinance found that microcredit failed to have a meaningful impact on entrepreneurship. **Ultimately, studies suggest that a borrower can prosper only if he can scale his businesses and earn a return greater than the cost of debt. Because the cost of debt is so prohibitively expensive, this becomes almost impossible** (Liu & Roth, 2017).

Dichter notes: *“The bulk of microfinance practice remains microcredit. There has been a general assumption, promoted to donors and the public, that such credit leads to small business investment or asset creation by the poor and that this therefore is the link between widespread access of the poor to credit and their economic development. [We look] at the history of democratized credit and its relationship to growth and poverty reduction in the ‘northern’ developed countries, and [find] little evidence for the connection”* (Dichter, 2007).

In a meta study, the author notes *“Overall, we find no robust evidence of any significant impact on microenterprises. With regards to impact on poverty, there is no evidence [of] any strong positive impact.”* (Awaworyi, 2014)

Van Rooyen, Stewart & de Wet (2012), considering the impact of microfinance in Sub-Saharan Africa note that *“The available evidence shows that microfinance does harm, as well as good, to the livelihood of the poor”*. However, in the conclusion, the authors note that **microsavings initiatives have potential positive social utility, but microcredit does harm**. A further conclusion is that in some cases, microfinance *“can increase poverty, reduce levels of children’s education and disempower women”*. (van Rooyen, Stewart, & de Wet, 2012).

A study conducted on payday loans in America, where loans carry interest rates of ‘several hundred percent’, showed that payday loans cause bankruptcies due to worsening cashflow profiles of consumers (Skiba & Tobacman, 2015).

Another study on the microfinance crisis in Andhra Pradesh, India, notes that liquidity supplied into the market found credit-hungry consumers who wanted to increase consumption and roll debt. Lenders focused on this vulnerability, causing the area to be engulfed in political and social unrest (Taylor, 2011). There are obvious parallels in South Africa.

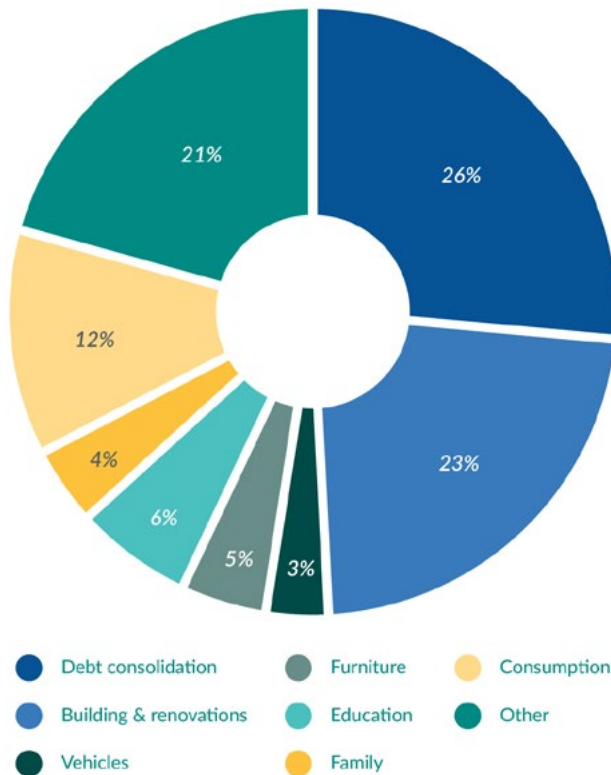
Members from Britain’s Institute of Fiscal Studies and the University of Oxford found that microlenders stray from their primary objective of delivering financial services to the poor. The motive becomes profit and new niche lending avenues (Augsburg & Fouillet, 2010).

A debate still rages in economic circles as to the effectiveness of microfinance. Again, we note that the argument here relates to microcredit for developmental purposes. Do the unsecured loans offered by South African lenders even qualify as microfinance?

The loans are also not being used to start businesses or for other purposes of self-actualisation. **In South Africa, financial inclusion through microcredit has become financial enslavement through debt traps**. In a study commissioned by the NCR (Compliance and Risk Services (Pty) Ltd, 2012), the self-reported utilisation of loans was as follows:



Figure 7: South African consumers of unsecured loans use the proceeds for consumption purposes

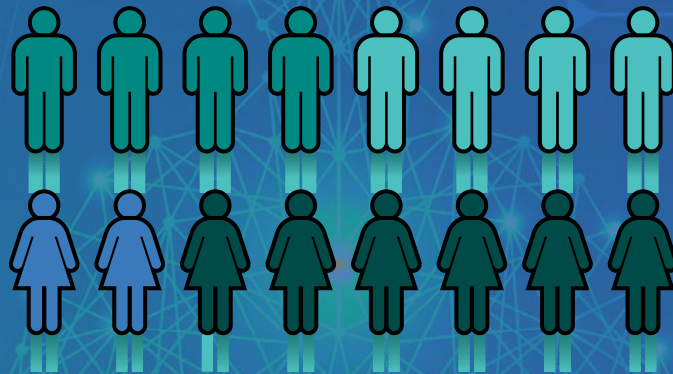


Source: NCR, Differential Capital estimates

Note that consumers polled for this type of information are usually economical with the truth, and we can assume that the results are worse than what is disclosed above. More than one-quarter of the loans are used to pay off other loans. One could only really contend that 'Building and renovations' (23%) and 'Vehicles' (3%) are constructive, although we would question the wisdom of renovating one's house at such high lending costs. The rest (74%) is for consumption purposes or borrowing to pay off other loans. **Expensive loans used for consumption purposes create a transfer of wealth from the borrower to the lender – in South Africa's case, from the poor to the rich.** This is the diametric opposite of the initial intention of the Usury Act exemption or the NCA.

One of the aims of the NCA is to "promote and advance the social and economic welfare of South Africans". Knowing that unsecured loans are incredibly expensive, likely to lead to a debt trap, and used for consumption purposes, we assert that these loans do not further this aim, and in fact are clear inhibitors of it.

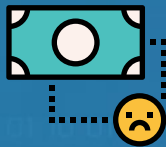




13 500 000
UNSECURED LOANS OUTSTANDING



ON AVERAGE, EACH PERSON HAS
1.7 LOANS



56%
OF UNSECURED
LOAN CONSUMERS
ARE IN DEFAULT

2/3 OF UNSECURED
LOAN CONSUMERS
PAY MORE THAN



25%
OF THEIR
NET INCOME TO
SERVICE THEIR DEBT

R225bn
OUTSTANDING AMOUNT
ON UNSECURED LOANS



R388bn
THE ESTIMATED CONTRACTUAL
AMOUNT THAT NEEDS TO BE
REPAID TO SETTLE THE LOANS



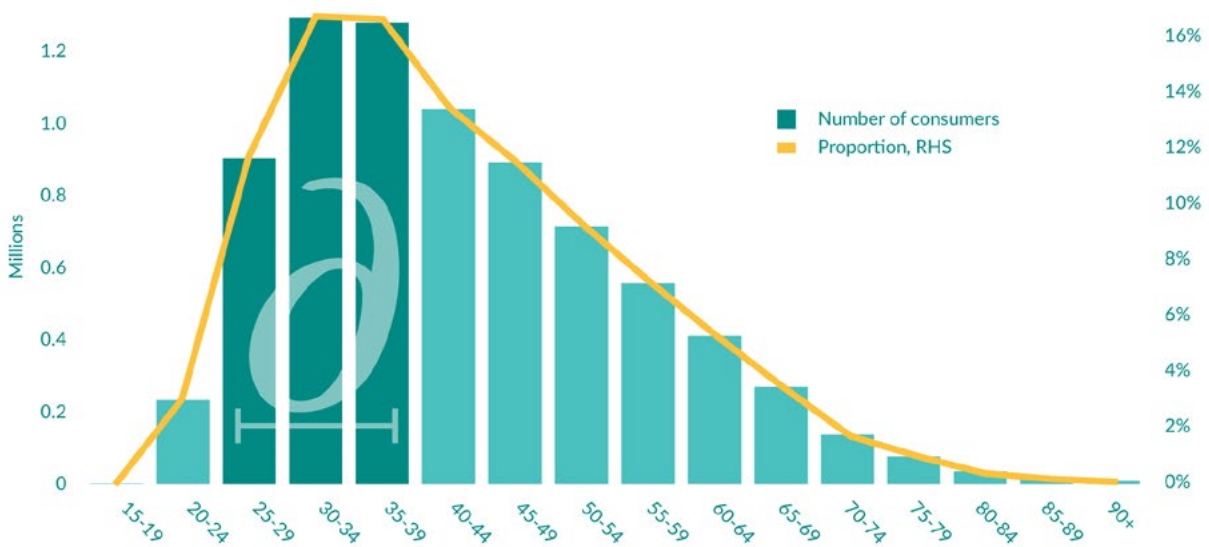
1.7x
OUTSTANDING
BALANCE



There are 19.3m credit-active consumers in South Africa, 7.8m of whom have an unsecured loan (c.40%).

As we show, **it is the least affluent and youngest credit-active consumers who have these loans.**

Figure 8: Consumers of unsecured loans are young – c.45% are between the ages of 25 and 40

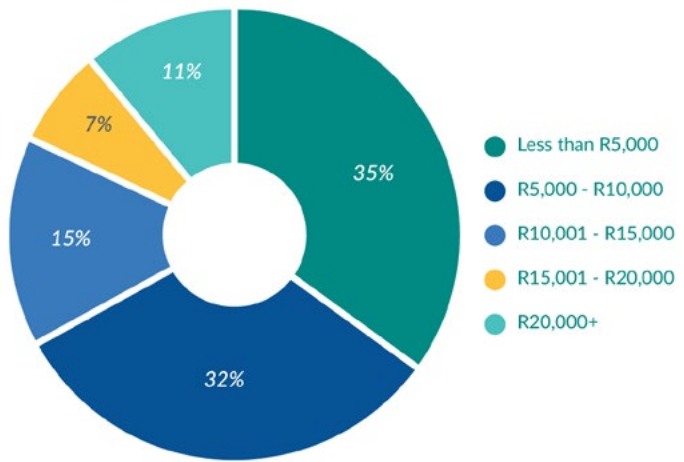


Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

⁵ A "thin file" consumer is one who has never had credit before



Figure 9: Income levels of consumers with personal loans. Note that income is gross and social grants are considered income



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

Public sector employees are prime targets for lenders – they have the most stable jobs and above-average wage increases.

This is the sweet spot for any lender, but especially an unsecured one. The opportunity to ‘grow’ with the client (i.e. offer larger and longer-term loans) is entrenched.

In Figure 10, we show that most consumers with personal loans in blue-collar industries are low-income earners. We contend that this is likely a large determining factor in labour relations, which can be inexorably difficult.

Figure 10: For consumers with a personal loan in a certain sector of employment, the proportion who earn less than R15k per month



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

WHO ARE THE LENDERS?

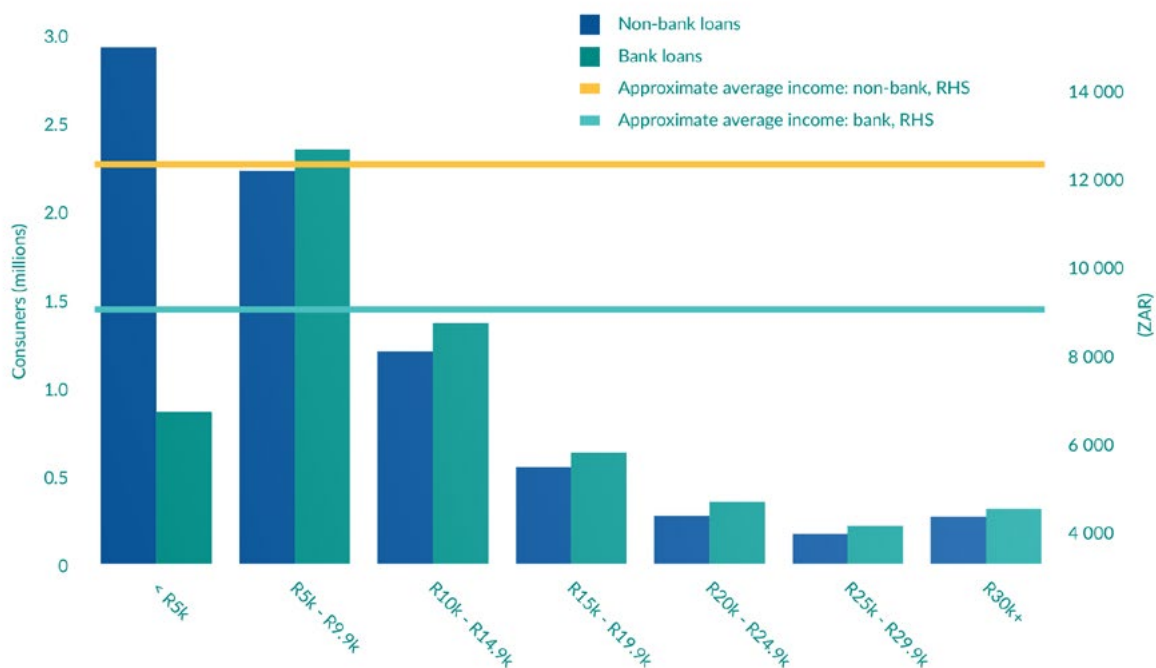


There is no shortage of lenders for unsecured loans. Mainstream financial institutions (not just banks) as well as smaller independent providers exist throughout the country. The Microfinance Industry in South Africa (MFSA) “represents more than 1100 Microfinance Credit provider offices”. There are also many illegal⁶ credit providers, most notably the *mashonis*. Wonga (itself an unsecured lender) estimates that there are more than 40 000 *mashonis* in South Africa – one for every 100 households (Wonga Finance SA (Pty) Ltd, 2017). The full list of lenders can be found at: https://www.ncr.org.za/register_of_registrants/registered_cp.php

We are only able to analyse registered credit providers as these institutions are required to submit data to the National Credit Regulator (NCR) and typically make use of credit bureaus. Using this data, we note that banks⁷ and non-bank lenders, despite the latter significantly outnumbering the former, still account almost equally for the number of loans in the industry; banks hold 55% of the volume of loans; non-banks hold 45% (excluding *mashonis*).

There is a clear distinction between banks and non-banks with regards to appetite for lending to consumers earning less than R5k per month.

Figure 11: Number of loans outstanding by income group: Non-bank lenders are dominant in the consumer segment earning less than R5k per month



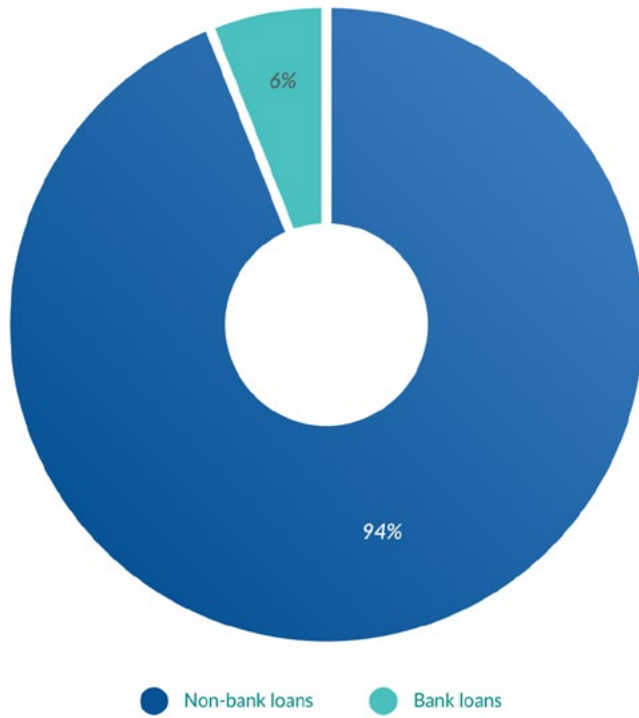
Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

⁶ Not registered with the NCR

⁷ Bank here is any provider with a banking licence. It, therefore, includes Capitec and African Bank, both of whom are significant participants in the unsecured lending market

These loans are the most destructive – i.e. payday loans.

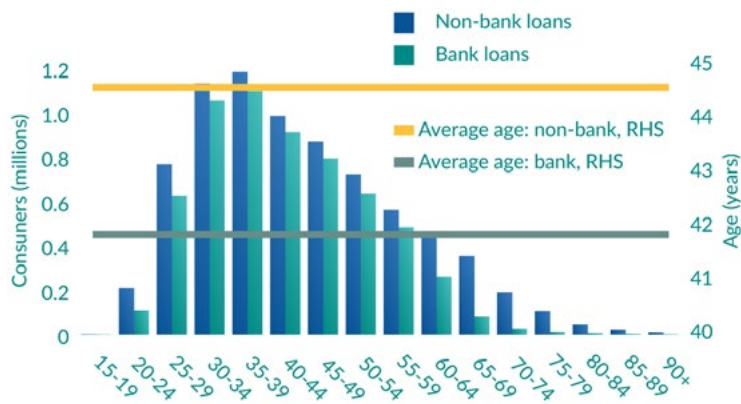
Figure 12: Non bank lenders dominate the payday loan market



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

Banks have a younger customer base on average.

Figure 13: Number of loans outstanding by age group: Banks have a slightly younger customer base, on average



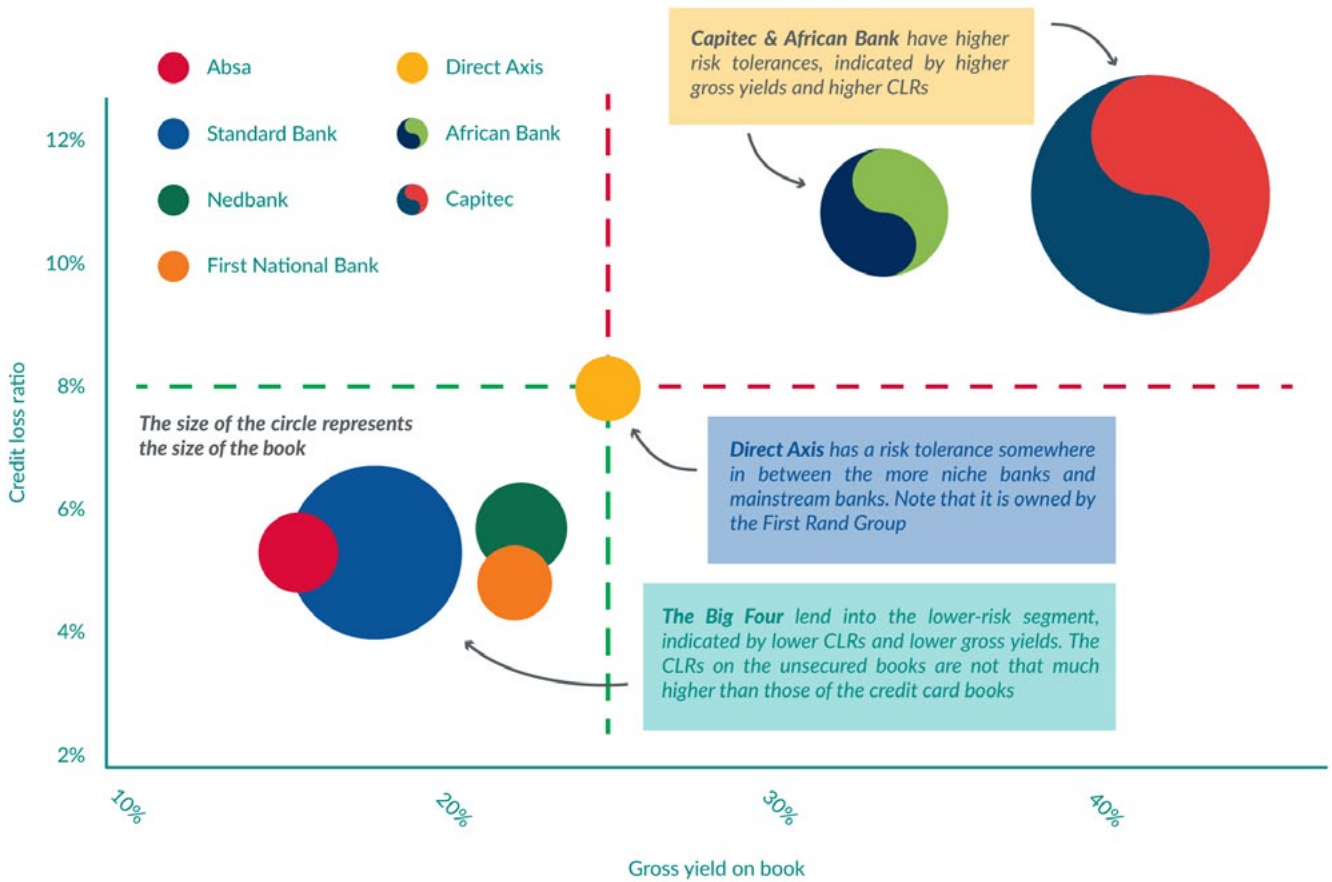
Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

It bears mentioning here that banks throughout this report are represented as a homogenous group. The reason we have done this is because we do not have access to disaggregated data for the banks.

However, **within the broad definition of banks, there are clear differences in risk appetite, and consequently potential for reckless lending.**

We show this in Figure 14.

Figure 14: Banks are not a homogenous group. The Big Four banks have materially lower gross yields and credit loss ratios, implying far lower risk tolerances



Source: Company disclosure, Differential Capital estimates



The niche lenders operate a different model – one that is riskier (as measured by gross yields and credit loss ratios). Direct Axis, part of the Firststrand Group, is somewhere in between. **Gross yields (i.e. cost to clients) for the big banks, on average, while high, appear to be somewhat defensible.**

The average yields on these books appear low relative to the all-in interest costs shown in Figure 4. The yields above represent only paying customers, i.e. money *actually* received, not money that was meant to be paid. This biases the cost estimate (gross yields). Paying clients effectively subsidise non-paying clients. If we could isolate this phenomenon, the risk-appetite divergence would be even more pronounced.

Since consumers have multiple loans, potentially from different lenders, the high-risk lenders impair the credit quality of the low-risk lenders. If there were no high-risk lenders, clients of low-risk lenders would be even lower risk.

The sector has been mired in controversy

Fast-growing books required even faster growing collection capabilities, and the industry quickly became embroiled in scandals related to abuse in its collection strategy. This resulted in the Department of Justice promulgating the Debt Collectors Amendment Bill 2016 which states in its preamble that “the victims of these abuses in the collection of debts are mostly the poorest and most vulnerable members of society” (Minister of Justice and Correctional Services, 2016).

The use of Emolument Attachment Orders (EAOs)⁸ became widespread as a collection mechanism for consumers who could not pay back debt. Many social commentators condemned their use due to a litany of abusive practices. The

⁸ Sometimes confused with, or used interchangeably for, “garnishee order”

University of Pretoria Law Clinic noted that c.12.2% of all employees in the public sector had EAOs against them, while the number was 6.7% in the private sector (University of Pretoria Faculty of Law, 2013).

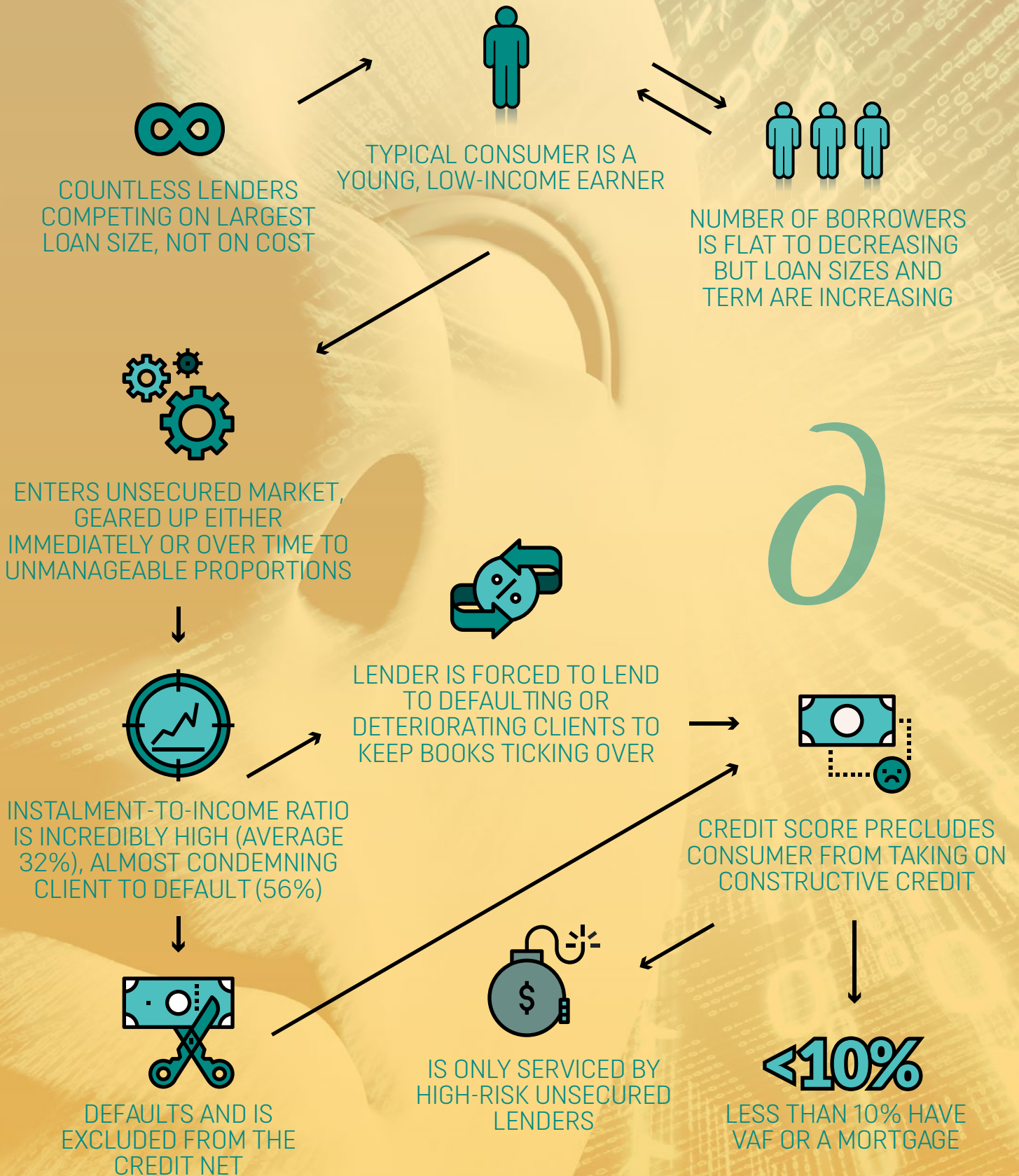
Note that EAOs are used when a consumer has not responded to all other methods of debt collection. The disgruntlement of mine workers at Marikana leading up to the tragedy in August 2012 was linked to excessive indebtedness and take-home pay being severely curtailed due to the use of EAOs (Stoddard, 2019). On 8 July 2015, High Court Judge Siraj Desai ruled EAOs as “unconstitutional” and an “assault on human dignity”.

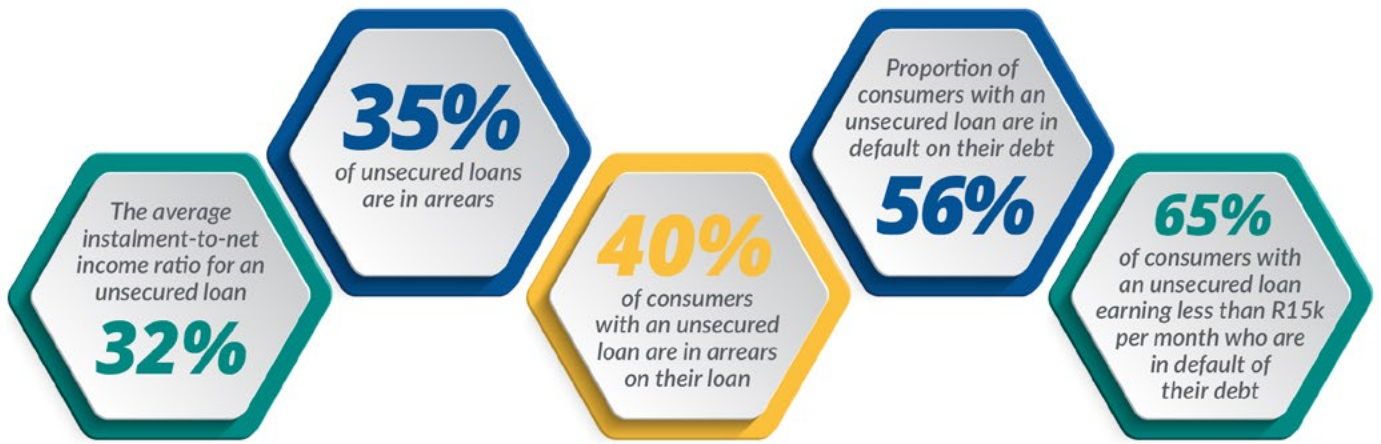
On 13 September 2016, the Constitutional Court, after a case brought to it by Stellenbosch University’s Legal Aid Clinic in 2015, attempted to stem the abuse by requiring that no garnishee order be issued unless the court authorised it (as opposed to a clerk of the court as was the case before).

Aside from the often-reported gross abuse of the collections system, the sector itself witnessed African Bank’s capitulation under the strain of excessive bad loans.



DOES IT CREATE A DEBT TRAP?

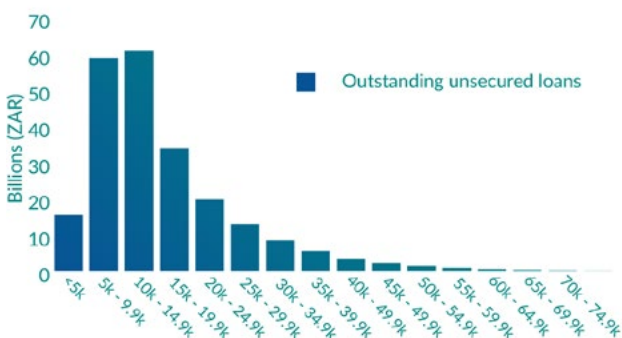




We question the wisdom of granting expensive loans to young, low-income earners, especially under the guise of financial inclusion. As we have shown, these initial loans are a gateway into larger and more longer-term unsecured loans and not more constructive forms of credit, the consequences of which are likely to be felt for years after the client enters the system.

We estimate the amount outstanding by income group. The results are shown in Figure 15. **People earning less than R15 000 per month owe c.R137bn (61%) in outstanding unsecured loans** by our estimates.

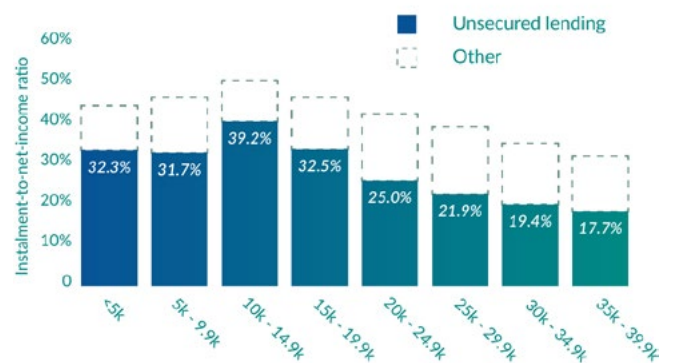
Figure 15: The majority of the outstanding c.R225bn unsecured book is owed by consumers earning less than R15k gross per month



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

We estimate further the instalment-to-gross income ratios, by income group, shown below:

Figure 16: The average instalment-to-net income highest for low-income groups.

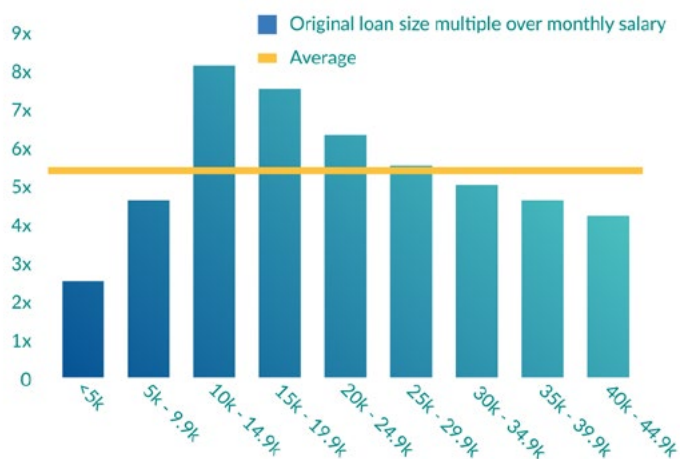


Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

Consumers of these loans (young, low-income earners) are paying almost one-third of their monthly net income to service them. Is it reasonable that someone earning R5 000 per month has R1 600 spare to service consumption debt?

Figure 17 shows our estimate of the average original debt relative to monthly gross income.

Figure 17: Even low-income consumers are granted loans that are multiples of their monthly incomes



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

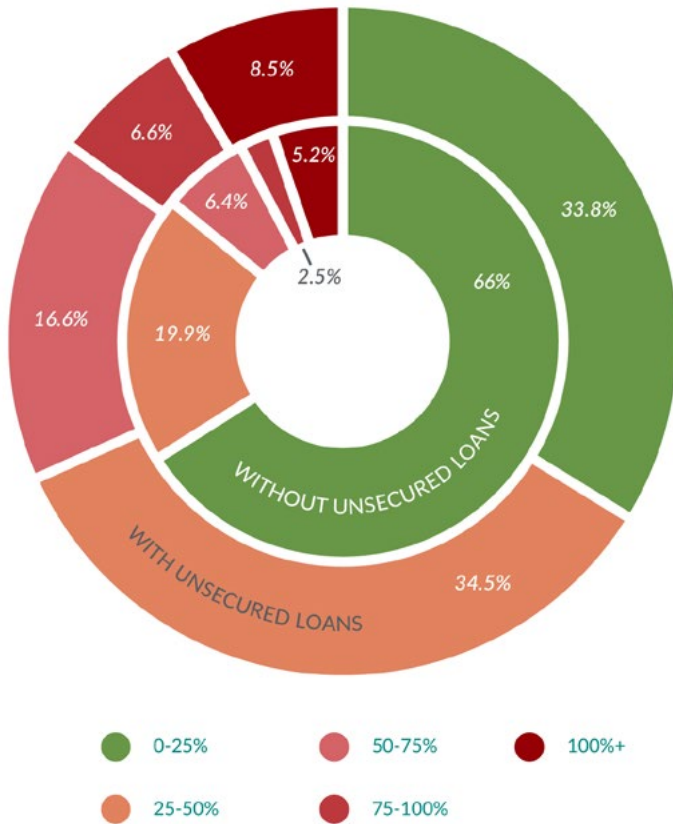
Is it reasonable to assume that an individual earning R5 000 per month can repay a loan of R12 500 – especially a high cost one?

Given that the repayment burden is as high as it is, one would correctly assume that the default rates on unsecured loans is high.

40% of consumers with an unsecured loan are in arrears on their loan. If one looks at consumers who only have unsecured credit (c.2m), the default rate is c.48%. If one looks at consumers with unsecured credit and other credit (c.7.8m), the default rate is c.56%, which compares to consumers without unsecured loans (c.11.5m) at c.35% (this includes other forms of unsecured retail credit such as overdrafts and credit cards, furniture loans, etc.). Loan level defaults are lower at c.35% but because consumers have many loans, on average, this figure is misleading.

We show below that consumers with unsecured loans tend to be excessively indebted relative to consumers without unsecured loans (but still other forms of retail unsecured credit like credit cards).

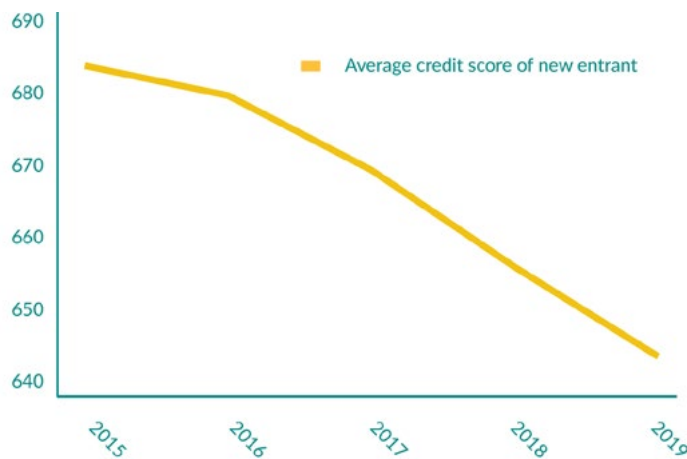
Figure 18: Consumers with unsecured loans have far higher instalment-to-income ratios than consumers without these types of loans



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

Recall that **the number of consumers is not increasing. Credit providers, attempting to grow, are lending to increasingly riskier clients, on average.**

Figure 19: "Thin file" clients receiving an unsecured loan are of increasingly worse quality



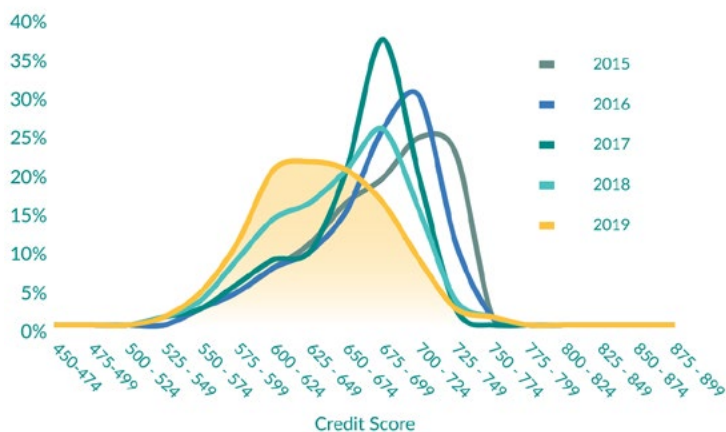
Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates





The distribution of credit scores paints an even dimmer picture, particularly in the last quarter (1Q19).

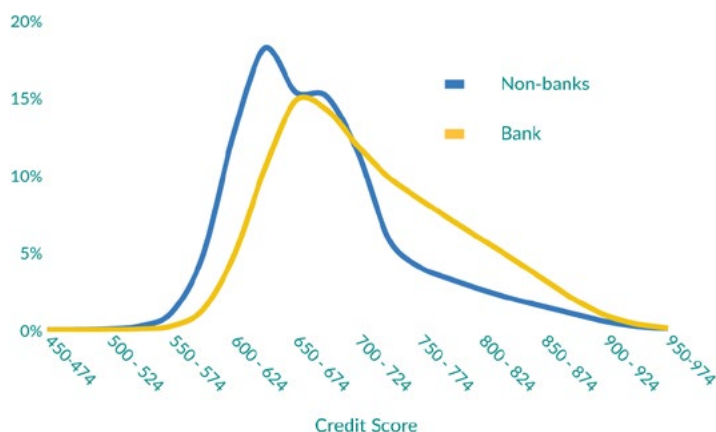
Figure 20: The quality of “thin file” consumer being granted an unsecured loan has continued to deteriorate (as is measured by credit score). A meaningful deterioration is evident in 2019 - growth observed has clearly come at the expense of quality



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

One may submit that it is the lower-tier providers shifting the quality metrics. There is some evidence for this.

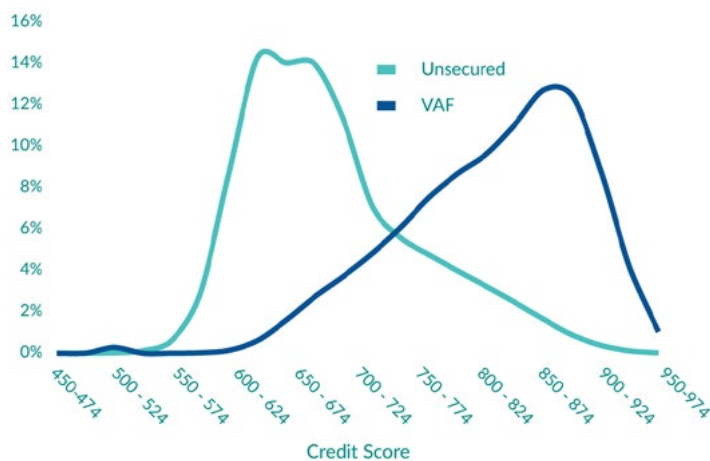
Figure 21: Banks appear to be taking less risk than non-bank lenders, although this is relative



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

On average, banks lend to higher-quality consumers than non-banks do, although both lend to poor quality consumers in absolute terms (with the caveat that banks are not homogenous as discussed earlier). If one compares the distribution of credit scores of VAF borrowers to that of unsecured ones, there is a marked difference in credit quality and not much overlap. The obvious outcome then is that **unsecured loans which tarnish consumers' credit worthiness are unlikely to serve as gateways into more constructive credit – a key expectation under financial inclusion.**

Figure 22: The risk profile of an unsecured borrower is markedly different to a VAF borrower



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

This is further evidenced by the fact that the proportion of consumers with unsecured loans that are in arrears on their debt has been consistently high. The 40% arrears ratio for consumers with an unsecured loan compares very unfavourably with the c.5% ratio for mortgages and VAF.

Consumers in arrears, with high instalment-to-income ratios, are not likely to be granted other forms of credit, especially a mortgage. This can be corroborated by noting that fewer than 10% of consumers with an unsecured loan have either a mortgage or VAF.

Figure 23: The high proportion of consumers with unsecured loans in arrears leads us to believe that it is unlikely they will receive other forms of credit, particularly mortgages



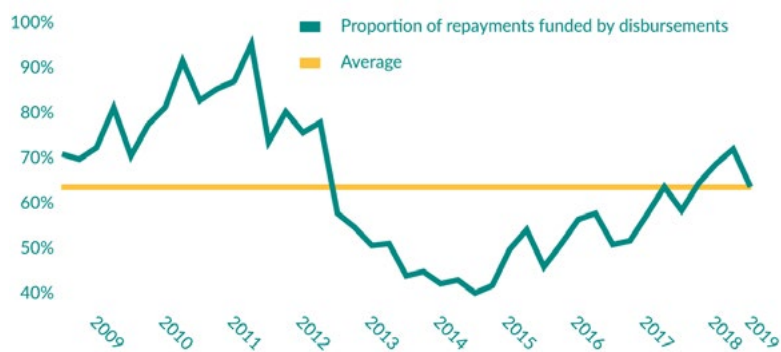
Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

Understanding the evolution of a single client who takes out an unsecured loan, even with aggregated credit bureau data, is challenging and subject to making assumptions. Nevertheless, we attempted to do this and obtained some key insights.

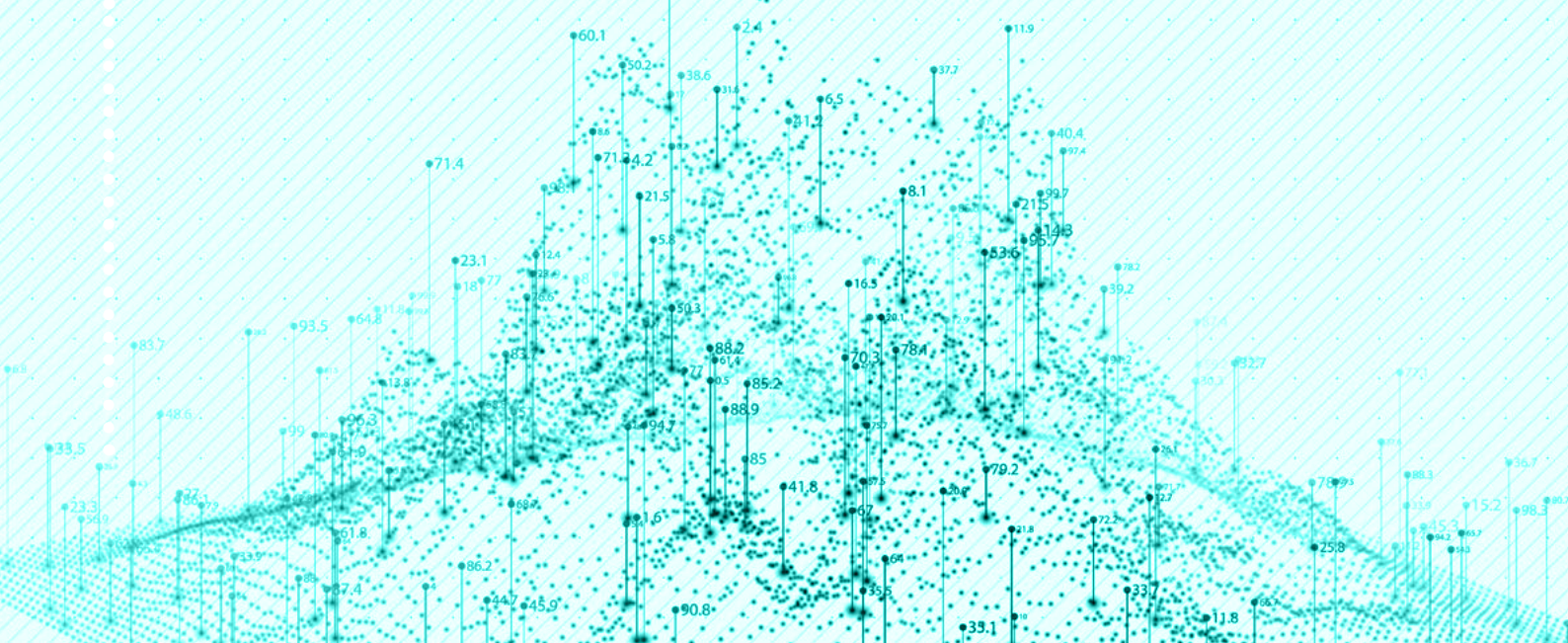
We believe that the broad trends are accurate, but the precise numbers should be used with caution.

A telling statistic showing that new debt is being used to pay off old debt is that disbursements fund almost two-thirds of contractual repayments, on our estimates. Recall that client numbers are not growing. Therefore, a largely homogenous set of clients are both the new borrowers and existing payers. Clients are likely “borrowing from Peter to pay Paul”.

Figure 24: Disbursements are, on average, 63% of contractual repayments. With net borrower numbers flat or decreasing, it implies high levels of consolidation or refinancing

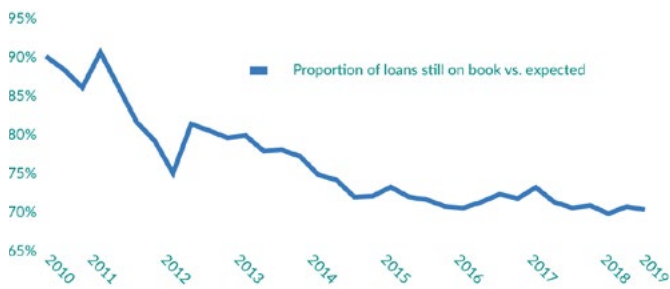


Source: XDS credit data - accessed through Eighty20 portal, NCR CCMR, Differential Capital estimates



We can corroborate this using a different methodology. When we know the term and number of loans disbursed in each quarter, it is simple to construct a matrix to ascertain how many loans one would expect to remain on the industry book. We can compare this number to the actual loans remaining. This is complicated only by the extent to which consumers not paying do not roll off the book.

Figure 25: There are far fewer loans on the book than the contractual repayment schedule would imply, indicating that loans are being consolidated



Source: XDS credit data - accessed through Eighty20 portal, NCR CCMR, Differential Capital estimates

Our analysis shows that there are 24% fewer 3-to-5 year loans and 21% more 5-to-10 year loans at the industry level than one would expect given the natural run-off curve. This tells us that 3-to-5-year loans are being converted into 5-to-10-year loans – a process

dubbed “terminating out”. We believe that this is being done for two reasons:

1. To manage defaults since a longer-term loan requires a lower payment, **or**
2. To facilitate growth since a longer-term loan allows for a larger loan, all else being equal.

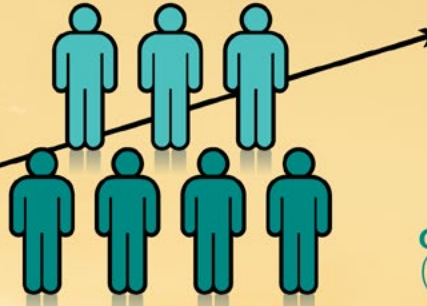
We can further corroborate this by working out the actual repayment rate for loan books greater than 12 months. Our analysis shows that 40% to 50% of the principal is paid off every year. This is high considering that the average term of new sales is almost four years. 75% of loans issued with terms longer than 12 months have terms of 36 months or more. This would imply a natural repayment rate of around 30% (vs. the actual rate of 40-50%).

Given that the repayment rate is unexpectedly high, despite high levels of arrears, it is highly likely that there is material rescheduling at industry level. This could be initiated by the lender, or by the client borrowing from one lender to pay another. This phenomenon could mask risk in the system, and this is unique to unsecured loans. When loans are backed by an asset, this type of recycling is not feasible.

MINING SECTOR

c.450 000
EMPLOYEES

c.300 000
CONSUMERS OF
UNSECURED LOANS



c.240 000
EARN LESS THAN
R15K PER MONTH

c.140 000
(58%) ARE IN DEFAULT

SPEND APPROXIMATELY **48%** OF MONTHLY NET
INCOME SERVICING DEBT

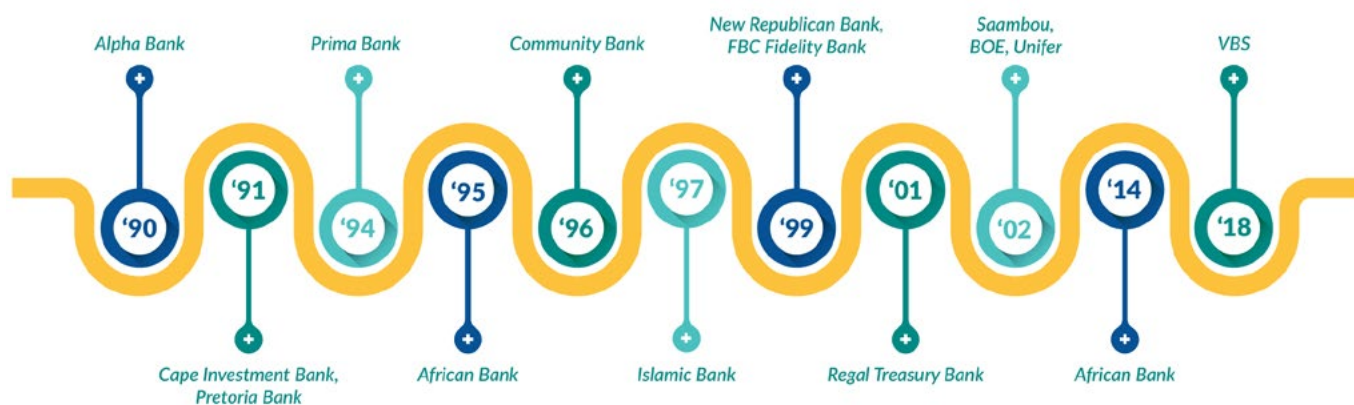
c.66% of people employed in the mining sector (including affluent executives) have personal loans. 240 000 (53% of all employees) have a personal loan, earn less than R15 000 per month and spend approximately R7 500 of the R15 000 repaying debt. Is this sustainable? Is it surprising that workers argue violently for significant wage increases?

Was the Marikana tragedy partly caused due to this form of lending? Some studies affirm that it did. (Stoddard, 2019). SA Law Clinics Stephan van der Merwe is quoted as saying "Reckless lending was one of the main grievances of the 34 striking miners massacred by police outside the Lonmin Platinum mine in North West Province. Many miners were left with virtually nothing at month-end after deductions in the form of EAOs were taken off their salaries" (Ryan Ciaran, 2019).

WHY WOULD LENDERS ENGAGE IN THIS FORM OF LENDING?

Given that this form of lending is unequivocally high risk, it begs the question – why do lenders do it? After all, we have seen several bank failures in South Africa, as shown below.

Figure 26: Bank failures in South Africa since 1990



Source: SBG Securities Research, Differential Capital estimates

This excludes the rescue of The Business Bank (now Capitec Bank) and Real Africa Durolink by PSG. We note that the failure of VBS was for political reasons. Nedbank faced severe challenges in 2003, and one could argue that the South African banking sector could have faced a major crisis were it not for Old Mutual.

Since 1990, one bank has failed every two years on average. When Saambou, Unifer and BoE collapsed, they were the sixth-, seventh- and eighth-largest banks

in the country, respectively (Leriba Consulting, 2013).

Micro-lending has also led to numerous bank failures in South Africa. While the largest banks in South Africa are mostly insulated from a fallout in the unsecured lending market, there are other financial institutions which could be considered systemically important that are not insulated from a fallout. The cost of bailing out depositors in the event of a banking crisis will have far-reaching effects and could lead to contagion.

Despite the high-risk nature of unsecured lending in South Africa, it remains incredibly profitable. This is due to the egregious charges levied on consumers to compensate for these risks.

We estimate the returns on equity (RoEs) for loans which do not default below⁸:

Figure 27: Annualised RoEs on non-defaulting loans dwarf all other forms of lending

2-6 months	534%
7-12 months	115%
13-24 months	67%
25-36 months	56%
37-60 months	39%
61-90 months	48%

Source: Differential Capital estimates

Clearly, at RoEs as high as above, one can tolerate high levels of default and still be extremely profitable.

Using our estimated all-in costs as per Figure 4, we calculate the length of time it takes for principal balances to be repaid per loan. We also compute the number of payments that are required to achieve an RoE of 30%, as well as to break even.



⁸ We assume a funding rate of SA government bond (matched maturity) + 3%, gearing of four times, and operating costs equal to 15% of the value of the loan

Figure 28: Due to the high-cost nature of unsecured loans, breakeven and 30% RoE inflection points are forgiving

Size of loan, ZAR	R8,000	R15,000	R30,000	R50,000	R120,000	R250,000
Tenure of loan, months	4	9	18	30	48	84
All-in annualised yield	180%	88%	55%	45%	34%	37%
Proportion of payments required to make RoE of 30%	85%	89%	90%	89%	93%	80%
Proportion of payments required to make breakeven	83%	85%	82%	77%	75%	57%

Source: Differential Capital estimates

Figure 28 shows that at the yields received on the books, the proportion of payments that need to be received to make an RoE of 30% is as low as 80% for some loans. Recall too that once default occurs, lenders have a myriad of possibilities to collect on bad loans and earn collection fees. **Sometimes, a defaulting but paying consumer is actually more profitable than a non-defaulter.** According to the Law Society of South Africa, “... it has become standard practice for such acknowledgments, undertakings and consents to include undertakings by the debtor to pay attorney-and-client or attorney-and-own-client costs, as well as collection commission. It is the latter type of undertaking that exposes vulnerable consumers to the risk of exploitation” (Hartzenberg & Buchner, 2013).

Collection fees levied on borrowers in default include administration and other charges. During our research, we spoke to lenders who candidly admitted that an irregular paying, but paying nevertheless, client was the most profitable type of client for their business.

There are many cases of abuse in the collections space. These relate primarily to in-duplum, EAOs, excessive collection and administration costs. The NCA prescribes the amount a lender can charge in lieu of collection costs, but lenders argue that legal fees are separate and do not form part of it. Suffice it to say that sometimes clients would pay in excess of 8 times their initial debt. The Law Clinic has been aggressively lobbying the courts, stating that the NCA was intended to protect lower income borrowers and is failing to do so. It argues that the high interest rates charged compensate banks for the risk of default, and they should not look to recoup massive fees in the event of default (Hartzenberg & Buchner, 2013).

Ultimately, lenders engage in this endeavour because it is highly profitable. Despite the many court cases and interventions, collection practices remain highly contentious as more court battles rage on. These collection abilities are required by the industry to sustain a product that, by design, engenders default. **One could argue that unsecured lending businesses are really collections businesses and not lending businesses.**



WHEN DOES THE PARTY END? :

It is our view that lenders maintain affordability, grow their books and stave off default by extending the duration of the loan. This strategy has diminishing marginal effectiveness because, as the term extends, the incremental extension results in a decreasing reduction

to the instalment. The total rand value of repayments, however, continues to increase rapidly – meaning that the utility for the consumer, in terms that they understand (i.e. multiple of loan repaid), declines rapidly.

Figure 29: Term extension beyond 60 months has almost no utility at high interest costs – the instalment is hardly reduced, and the borrower ends up paying for many more months

Term	1	24	48	60	84	108	132	156	180
Instalment	103 333	6 119	4 205	3 875	3 560	3 433	3 378	3 353	3 342
Reduction in instalment		97 215	1 914	330	315	127	55	24	11
All-in cost	40%	40%	40%	40%	40%	40%	40%	40%	40%
Loan size	100 000	100 000	100 000	100 000	100 000	100 000	100 000	100 000	100 000
Multiple of loan repaid	1.03x	1.47x	2.02x	2.33x	2.99x	3.71x	4.46x	5.23x	6.02x

Source: Differential Capital estimates

Figure 30 shows that the average loan term of new sales in 1Q19 is at peak levels – levels equalling those witnessed prior to the collapse of African Bank.

Figure 30: Average loan term of new sales is now at peak levels – equalling those witnessed prior to the collapse of African Bank



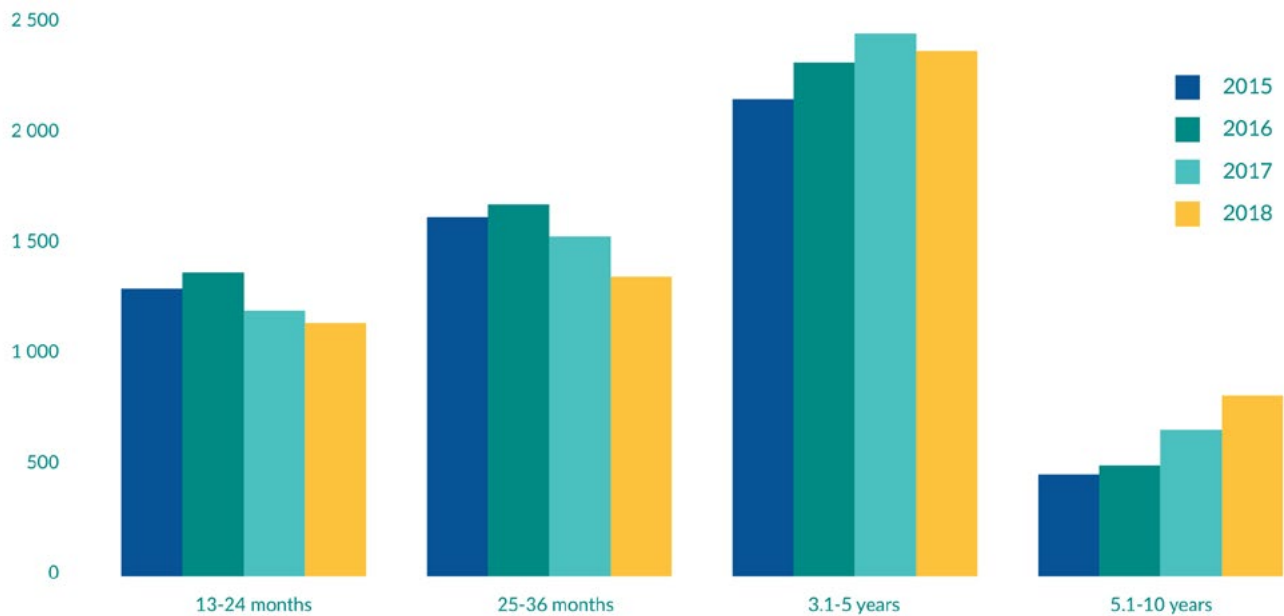
Source: NCR CCMR, Differential Capital estimates

Mathematically, extending term beyond 44 months will still help consumers with affordability and could continue to suppress true risk in the system. However, we caution that the number above is an average. The way consumers are stratified means that the real number at which term extensions becomes untenable is likely to be much lower. Some consumers, such as domestic workers, would never receive a loan with a term longer than a couple of months.

Loans outstanding are shifting from 3-to-5 years into 5-to-10 years – likely as a result of rescheduling. This will have the effect of obscuring the true levels

of risk, though it cannot continue indefinitely due to diminishing marginal utility.

Figure 31: Outstanding loans are shifting away from 3-to-5 year loans into the 5-to-10 year loans



Source: XDS credit data - accessed through Eighty20 portal, Differential Capital estimates

Given that the term on new loans is approaching peak levels, it is reasonable to assume that a correction could be imminent.





WHAT ARE THE RISKS TO SOCIETY?

The most unforgivable repercussions of the unsecured lending industry, beset as it is by scandals and pervasive reckless lending, was the tragedy in Marikana. We do not mean to insinuate that mine worker indebtedness was the only factor, but we contend that it certainly contributed. The Marikana tragedy opened old wounds in our fledgling democracy, harking back to the Sharpeville Massacre in 1960. We believe that the rise in populist sentiment and divisive rhetoric, particularly among disenfranchised and impoverished youth, can be attributed to what took place at Marikana. ***The sting of these loans, particularly in the context of a country grappling with high levels of inequality, cannot be underestimated.***

While the endeavour to widen the economic and credit net to previously excluded individuals was a noble one, the change in legislation has only served to deeper entrench the inequality and create financial pariahs out of the communities the legislation was intended to serve. ***Far from being mechanisms by which poor black South Africans could extricate themselves from poverty, high-cost unsecured loans used for personal consumption by largely financially illiterate consumers have blighted the chance of financial emancipation for many.*** All the while, unscrupulous and opportunistic lenders have proted handsomely.

Consider the spending power that these loans have robbed from the c7.8m consumers, and consequently, the economy. Today's frivolous consumption comes at the expense of tomorrow's investment. In addition, the long tenures, debt-trap-like nature of the product and exorbitant interest rates mean that future consumption and investment expenditure is diverted into the coffers of a small subset of lenders.

According to Bateman (2014), excessive consumption spending is detrimental to long-term growth. South Africa's economy is likely still reeling under the massive consumer strain of these loans. Instead of investing into the economy, buying homes, spending on healthcare, durables, etc., consumers are mired in debt that will last for years to come.

The opportunity cost of these loans remains a key drain on the economy, and indeed society. Note that ***many public sector employees have unsecured loans. Indirectly, it is South African taxpayers who repay these loans. This creates a drain on the fiscus. Tax money that could be used for pro-economic growth initiatives is being funnelled to unscrupulous lenders who will keep relending for as long as these individuals remain employed.***

Let us once again refer to the stated purpose of the NCA:

1. “to promote and advance the social and economic welfare of South Africans”
2. “promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry and”
3. “to protect consumers while balancing the rights of suppliers”

On Point 1, we think it is clear that the new lending paradigm, which led to the explosion of unsecured loans has been wholly damaging to the social and economic welfare of South Africans, particularly to the poor (the overwhelming majority of whom are black – the very group whose disenfranchisement was the genesis for the change).

On Point 2, we argue that the unsecured credit market is:

- not fair because consumers are highly likely to find themselves in a debt trap
- not transparent because the limits on interest rates are circumvented through malicious add-on products
- not competitive because lenders do not compete on the best value for consumers (i.e. price)
- not sustainable because 40% of consumers with an unsecured loan are on default on the loan
- not responsible for all the reasons above

With regards to Point 3, it is obvious that consumers are not being protected. There is a wealth of evidence and case law to support this. While an inspection of the actual

legislation is beyond the scope of this report, enforcement of the legislation is especially poor, and punitive measures against reckless lenders are almost non-existent.

The most poignant example in this regard would be African Bank being fined only R20m for reckless lending – a rounding error given the scale of the business - one year before it crumbled under the strain of its reckless lending.

To quote Bateman (2014): **“As in many other locations where such a financial intermediation structure has emerged, the end result in South Africa has been the deindustrialisation, informalisation, disconnectedness and primitivisation of the average local community, and so a poverty trap has effectively been created thanks to microcredit.** In addition, the inequality, greed, aggressive competition, and unfairness that is effectively underpinned by the microcredit model have combined to undermine and destroy the important solidarity bonds both within and across South Africa’s local communities. This does not bode at all well, of course, for a country desperately attempting to cast off its vicious apartheid legacy and to move into a new era of social justice and inter-racial accommodation. Like a rapidly growing weed that hogs the sunlight and nutrients required by the slow growing crops around it, the microcredit sector in South Africa has appropriated large quantities of scarce capital, technical expertise, goodwill and government policymakers’ attention, all in order to help construct a primitive, unequal and ‘no-growth’ economic and social structure that is frustrating the legitimate aspirations of previously suppressed communities attempting to survive in the post-apartheid era”.



WHAT ARE THE SOLUTIONS?

A sustainable unsecured credit market is one which supports the stated purpose of the NCA. The Act itself prescribes robust affordability assessments, but these are routinely circumvented or ignored, and enforcement remains a key issue. We believe that instituting the following measures will lighten the enforcement burden and achieve the result that the NCA desires:

1. Limit the allowable loan size to the lower of 25% of annual net income or R40 000 for consumers earning below R15 000 per month net, and the lower of 35% of annual income, or R100 000 for those earning more than R15 000 per month net. Enforcement of this is likely to be far easier as income is more easily verified than expenses. The maximum limit also ensures that even if the letter of the law is ignored, the damage is severely curtailed relative to the current paradigm. The NCA, as it currently stands, makes no prescription on loan size.
2. Limit the maximum term of a loan to three years. This will prevent long-term consumption loans, which create debt traps, but is long enough to facilitate affordability to lower-income earners. Enforcing this should be reasonably simple as credit bureau data dumps can be used to identify non-compliant lenders immediately.
3. Limit the all-in cost of a loan to the minimum of prime + 15% and 30% (this includes service and initiation fees) and forbid bolt-on products. The NCA in its current form is indeed prescriptive on fees and interest charges, as well as charges on credit life insurance. However, lenders are creative in ensuring



that the all-in yield reaches desired levels by bundling other products onto the loan. It is impossible to regulate each type of add-on product and hence a blanket ban is more appropriate.

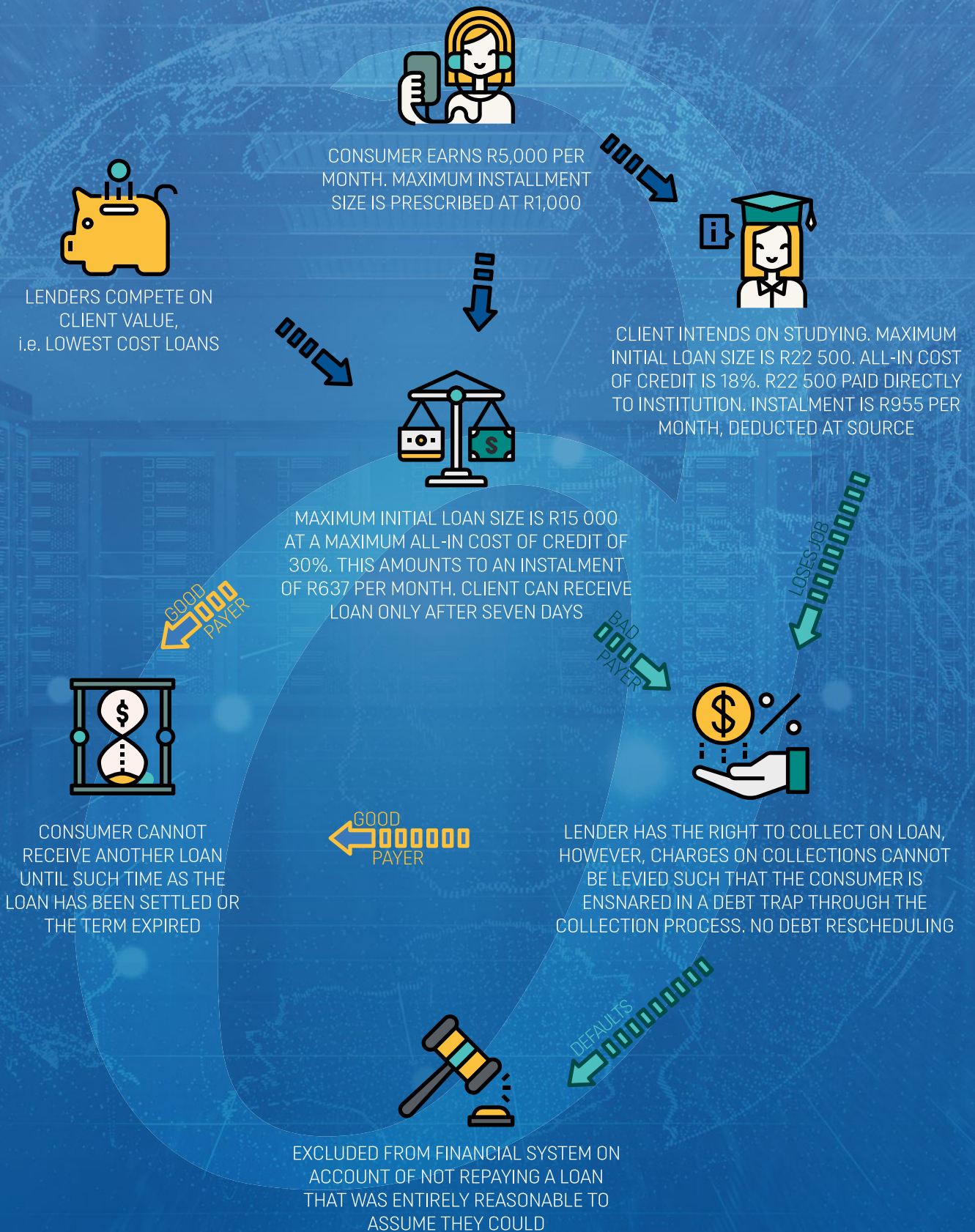
4. Limit the instalment on an unsecured loan to 20% of net income but continue to conduct affordability assessments to ensure that this is appropriate given the client's individual financial circumstances. The issue of excessive gearing that we currently witness in the industry should be alleviated, and the effects of gross non-compliance with affordability assessments will be improved.
5. Limit the maximum number of unsecured loans per client to one and forbid debt consolidation and debt rescheduling. Due to the nature of the industry, lenders are compelled to compete on the size of the loan because a prudent lender, by being judicious and responsible in their credit granting, simply allows the buffer to be exploited by an unscrupulous lender. To stay relevant to the consumer, even prudent lenders are forced to assume more risk than they would do in a vacuum. By limiting a client to one loan and forbidding consolidation, this is no longer a consideration.
6. Limit consumers to a maximum of three payday/monthly loans per year. Doing this ensures that the previous suggestions are not circumvented by simply rolling one-month loans ad infinitum.
7. Institute a cooling-off period of seven days. Loans are currently disbursed within twenty minutes, even those as large as R350 000. The ability for consumers to access immediate liquidity is incredibly alluring. Forcing lenders and consumers to wait seven days until pay out reduces the likelihood of impulse loans that often result in unforgiving multiyear debt traps.
8. Encourage lending for developmental and constructive purposes by allowing payroll deductions when loans are paid directly to suppliers. These loans must have

a cost capped at the minimum of prime + 7.5% and 18%, and can also be 150% of the size of the maximum prescribed loans. The definition of a developmental/constructive loan must be extremely narrow, and recipients of these loans must register with, and be vetted by, a competent authority. In doing this, constructive credit consumption in the true spirit of microfinance is promoted. The type of developmental suppliers could be educational facilities, small business enablers, affordable housing loans, etc.

9. The Act must be incredibly prescriptive on allowable collection costs to be levied against defaulting consumers. This will prevent unfair collection practices and result in more judicious lending. Lenders' ability to collect must not, however, be impeded. Practically though, this means that lenders would have to seek out low-risk consumers because expensive legal fees to collect must be the exception and not the norm.

A non-prescriptive way the industry can be transformed would be to increase the Risk Weighting to 1 000% for any loans which have been rescheduled. This must be done at the consumer level as opposed to the bank level. In other words, a client who is staying current by having many loans from different providers will attract a punitive 1 000% RWA. Unless the lender is certain that the client will not default, the loan becomes infeasible. Furthermore, the lender is forced to hold 100% capital against the loan, meaning that the risk to society post a run on the lender is materially reduced.

SUSTAINABLE UNSECURED LENDING MARKET



The above measures are likely to restore the market to something more sustainable and equitable for both consumers and suppliers. However, it does not solve the problem of existing loans. Here, we suggest that existing loans are reconfigured within the paradigm of the new rules, and where they cannot be (which will be the vast majority), we suggest a Toxic Asset Repurchase Programme.

We estimate that government employees owe c.R75bn in unsecured loans and that approximately 1.1m government employees have unsecured loans (c.85% of all government employees). This means that each government employee with an unsecured loan owes c.R67 000 on average.

We propose that the government repurchases these loans, collateralises them against the employees' pension funds, recontracts the loans at the current outstanding term and a 15% interest rate, and collects on these loans at source. The infrastructure to do so already exists.

The major challenge would be to find the cash to settle these loans. We propose using the workers pension fund. Unless the fund earns more than the cost of credit, employees will be far better off. Government (or the fund) would earn R11.4bn over three years and consumers would be getting a fair deal, paying less than one-half in absolute terms of what they would have (we estimate that on current contractual terms, government employees will pay back c.R116bn on this debt of c.R75bn).

Most importantly, government employees will be emancipated from the debt trap in which they currently reside. As primary targets of these types of loans due to stable jobs and above-inflation wage increases, it is unclear how this debt spiral will end without intervention. ***Government employees account for 14% of the unsecured client numbers, but c.35% of the outstanding loan balances. The average loan balance outstanding for a government employee is c.R67 000 vs. c.R22 000 for everyone else.***

Without a method of deducting payments for loans at source, we cannot recommend any other intervention for the rest of the industry, except that loans to social grant recipients should be banned. The change in rules we articulated earlier will ensure that as consumers pay down the debt they already owe, they will not find themselves in a similar predicament again. Furthermore, collection abuses should abate if the NCA is prescriptive on the costs that can be charged.

A few days before going to print, President Cyril Ramaphosa signed into law the National Credit Amendment Bill. It allows debt restructuring for consumers earning less than R7 500 per month, have unsecured debt of R50 000 or more, or have been found to be critically indebted. It makes provisions for debt to be repaid over five years and potential extinguishing of the debt. Critics of the Bill argue that it will reduce financial inclusion – a notion we reject for reasons articulated throughout the report. While we obviously approve, philosophically, the attempt to correct the industry, we have some reservations about the Bill. We are in favour of expunging the debt of loans which were granted recklessly, but caution that being prescriptive of amounts and income sizes could destabilise credit markets. Furthermore, legislation should aim to stem abuse before it happens. If it is the view of policymakers that people earning R7 500 per month are being exploited by unsecured lenders, then policy should be prescriptive on the terms of lending to this sector of society.

As drastic as the changes we propose may be, we believe that it is entirely necessary for the sake of the consumers and the country as a whole.

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