



MAKING FINANCIAL MARKETS WORK FOR THE POOR

**HOW LOW CAN YOU GO?**  
**CHARTING THE HOUSING FINANCE ACCESS FRONTIER: A**  
**REVIEW OF RECENT DEMAND AND SUPPLY DATA**

25 April 2006

Prepared for the FinMark Trust by  
Illana Melzer



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

---

▲ **Trustees:** NL Sowazi (Chair), EG Matenge-Sebesho, M Mogase, M Napier (CEO), DJ Porteous, RSK Tucker

*Acknowledgements*

*Many thanks to Kecia Rust for her insightful comments that ensured that the analysis always focused on the question of access. All errors and omissions remain the responsibility of the author.*

## EXECUTIVE SUMMARY

As part of the Charter process, the financial sector has committed to providing R42 billion of housing finance to the low income market, defined as those with a monthly household income of between R1 500 and R7 500, by the end of 2008. Since the publication of the Financial Sector Charter ("FSC") in 2003, three of the country's four largest retail banks have begun actively marketing mortgage products aimed at the FSC target market. While this is a positive development, it is important to assess to what extent these products meaningfully enhance access to housing finance in the low income market.

As a first step, it is necessary to define the term 'access' and to distinguish between access and usage. Many more people may have access to a product than those who choose to use it. While usage is usually directly observable, access, in contrast, can be more difficult to gauge. Porteous (2005) has developed a useful framework, termed the access frontier, for assessing access. This framework segments the market into a number of market zones corresponding to various levels of access;

- *Current market:* This zone comprises those who currently have or use the product (who by definition have access to the product),
- *The market redistribution zone:* Those who are lie beyond the reach of the product because they are too poor lie in the *market redistribution zone*. Households in this zone will require non-market interventions such as subsidies to enable them to meet their housing needs.
- *The market enablement zone:* Those who are within reach of the market but who do not currently have the product lie in the market enablement zone. This zone can be further sub-segmented into those who actively choose not to have a product and therefore lie beyond the natural limits of the market and those who have not yet purchased the product but are candidates for doing so.
- *The market development zone:* This zone comprises those who cannot access the product given their location or income profile and the product's current pricing structure but who are likely to be able to access the product in the near-term given the likely trajectory of product innovation and / or market dynamics.

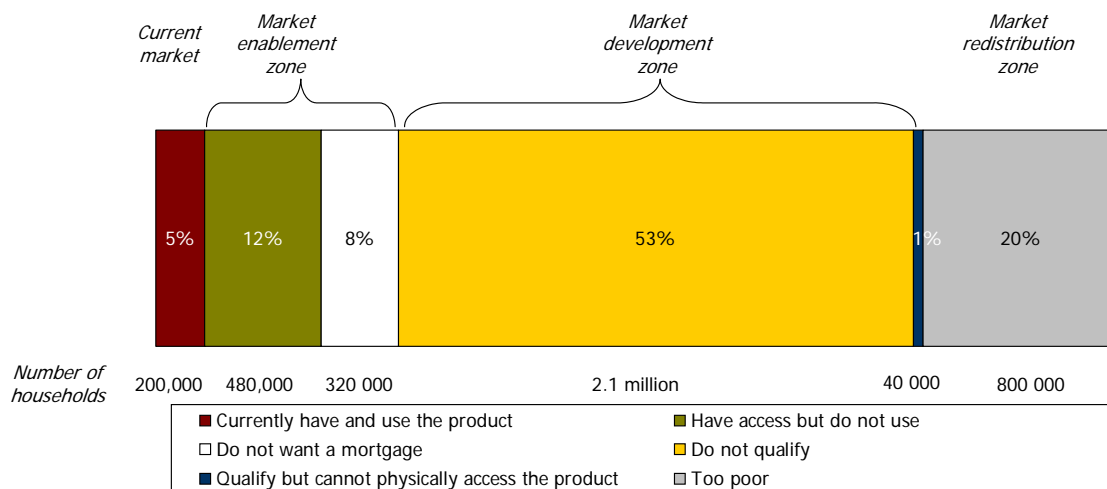
The application of the access frontier methodology to mortgage finance is complicated by the circular dependence of finance on the availability of the underlying housing asset. Potential borrowers who may otherwise qualify for a mortgage loan and who lie in what is termed the market enablement zone may be unable to access housing finance if they cannot find a suitable house.

While any housing shortages will clearly impede access to mortgage finance, in order to apply this framework to mortgage products, it is necessary to assume that there is fundamentally

no housing supply constraint that prevents households that would otherwise qualify from obtaining a mortgage. This line of enquiry, while clearly a simplification, establishes the degree to which existing mortgage products can be accessed by the target market purely on the basis of borrower characteristics alone. It therefore provides an indication of the nature and magnitude of borrower-related access barriers and indicates the extent to which existing mortgage products could support any additional housing supply that might be made available for the target market in the future.

The access frontier has been populated using data on the characteristics of the market derived from various surveys together with lender assessment criteria. The analysis indicates that 75% of the households in the target market are unable to access the product because they are too poor (20% of the target market) or because they fail to qualify because of factors such as age, credit quality or capacity to service mortgage finance. Approximately 20% of the target market has access to bank-provided mortgage products but has not yet obtained the product. A sizeable proportion of households in this market zone appear not to want a mortgage.

Chart 1. Access frontier for mortgage finance in the target market



Source: Underlying data based on FinScope™ 2005 using household heads

Note: percentages do not add up to 100% because of rounding

Clearly any shortages of suitably priced, mortgageable housing stock would effectively prevent households who lie in the market enablement zone from accessing a mortgage. The analysis of the characteristics of existing formal, owned houses in the target market indicates that over 60% are not considered mortgageable by banks using current commonly applied property criteria. In addition, excluding RDP houses (many of which are not considered mortgageable) the stock of low-cost housing units is augmented by less than 20 000 units

per annum. In contrast, data on the nature and adequacy of housing in the target market indicates that over 870 000 units<sup>1</sup> are required to adequately house those in informal dwellings and overcrowded formal dwellings.

However, while the stock shortage is clearly significant, it is not clear to what extent it impacts on those within the mortgage market enablement zone. Many households who would qualify for a mortgage loan may be adequately housed or may succeed in purchasing one. Likewise, many of those who cannot find a house may not qualify for a mortgage in the first instance.

Deeds office data presented as part of the Banking Association research into housing supply and functioning markets indicates that around 70 000 affordable houses are mortgaged a year. If the true market size of those who qualify for a mortgage is 480 000 households, there does not appear to be a significant mismatch between those who qualify for a mortgage and those who can actually obtain one (15% of qualifying households obtain a mortgage each year, indicating that within seven years, total demand would be met holding all things constant).

It is no doubt the case that access to mortgage finance could be enhanced if lenders restructured and optimized the structure and processes associated with existing mortgage products to align more closely with the needs and characteristics of the target market. Mechanisms that could enable such optimization include improved loan servicing processes, redefined borrower, property or area criteria, loan level product features such as insurance or collateral requirements as well as portfolio interventions such as guarantees. To date, it appears that banking industry efforts have focused on the latter. Banks have requested a government guarantee to limit losses associated with mortgage lending in the low income market arising from non-commercial risk. However, it is not clear to what extent such a guarantee would result in an increase in access to mortgage finance. Banks are unwilling to disclose data on the percentage of applications that are rejected and the associated reasons for rejection. They have also not disclosed their policies with regard to areas which are deemed to be unsuitable for mortgage finance. It is therefore not possible to determine how many currently rejected loan applications could be accepted if the guarantee was in place nor how the housing market could be expanded if area restrictions were lifted.

There is a limit to the extent that mortgage products, even if optimized, can facilitate access to housing finance across the target market. Data on the nature of the housing need and the

---

<sup>1</sup> This estimate differs from the estimate of 650 000 units derived by the Banking Association which focuses on households in the FSC target market with a minimum monthly household income of R2 500.

financial and risk profile of households in the target market highlights the need for a range of housing finance products, most notably, incremental housing loans.

While the banking industry's emphasis on larger mortgage products is not surprising given the focus on meeting the FSC target and deadlines, smaller, non-mortgage products are at least as important as mortgage loans. Such products could enable the transformation of currently sub-standard units into mortgageable housing stock, facilitating the creation of wealth. They would also provide banks with a lower risk mechanism of engaging in the low income housing finance sector and developing a more robust understanding of the risk profile of the market. While banks may not have the required capabilities to operate effectively in this product space, there may well be opportunities to partner with existing housing lenders who do.

## TABLE OF CONTENTS

INTRODUCTION .....	8
THE TARGET MARKET .....	10
<b>The need for housing and housing finance in the target market.....</b>	<b>11</b>
<b>Other characteristics of the target market .....</b>	<b>13</b>
<i>Income and income sources.....</i>	<i>13</i>
<i>Household size and composition.....</i>	<i>15</i>
<i>Exposure to, and ability to absorb, financial shocks .....</i>	<i>18</i>
<b>Summary.....</b>	<b>21</b>
SUPPLY OF MORTGAGE PRODUCTS IN THE LOW INCOME MARKET .....	22
<b>Product features of home loans in the low income market .....</b>	<b>23</b>
<i>Interest rate .....</i>	<i>23</i>
<i>Fixed or variable rates.....</i>	<i>24</i>
<i>Product term.....</i>	<i>25</i>
<i>Size of the loan.....</i>	<i>25</i>
<i>Readvance (access bond) facility.....</i>	<i>26</i>
<i>Deposit and loan-to-value ratios.....</i>	<i>26</i>
<i>Insurance riders.....</i>	<i>27</i>
<i>Payment flexibility.....</i>	<i>28</i>
<i>Borrower education.....</i>	<i>28</i>
<b>Summary.....</b>	<b>28</b>
CREATING THE ACCESS FRONTIER FOR MORTGAGE FINANCE IN THE TARGET MARKET.....	31
<b>The current market for mortgage finance .....</b>	<b>33</b>
<b>The market redistribution zone .....</b>	<b>37</b>
<b>The market development zone .....</b>	<b>39</b>
<i>Borrower fails to meet lender criteria.....</i>	<i>39</i>
■ <i>Affordability.....</i>	<i>39</i>
■ <i>Credit history.....</i>	<i>41</i>
■ <i>Age.....</i>	<i>41</i>
<i>Property or area fails to meet criteria .....</i>	<i>41</i>
<i>Other barriers to access.....</i>	<i>43</i>
<i>Summary: Market development zone.....</i>	<i>43</i>
<b>The market enablement zone .....</b>	<b>43</b>
<b>The access frontier for mortgage finance .....</b>	<b>45</b>
<b>Other external barriers to access - Cannot find an affordable house.....</b>	<b>46</b>
ACCESS TO HOUSING FINANCE IN THE LOW INCOME MARKET – THE CHALLENGE FOR BANKS .....	50
APPENDIX A .....	56
<b>Data sources .....</b>	<b>56</b>
<b>References .....</b>	<b>56</b>
<b>Interviewees.....</b>	<b>57</b>

## INTRODUCTION

Participants in the Financial Sector Charter ('FSC') process, including banks and insurance companies, have committed to providing R42 billion worth of housing finance for the low income market, defined as households with a monthly income of between R1 500 and R7 500<sup>2</sup> by December 2008. All types of housing finance are incorporated in this target, including end-user finance as well as project and development finance<sup>3</sup>.

Three of the four large retail banks have recently begun actively marketing mortgage products to households with a minimum monthly household income that coincides with, or is close to, the lower bound of the FSC target market of R1 500 per month. While this is a positive development, two fundamental questions remain: what percentage of the target market *actually* have access to these products, and to what extent will these products enable banks to transform the low income housing finance sector?

At the outset, it is important to define what is meant by access and to distinguish between access and usage. Usage is directly observable and can be tracked by reviewing metrics such as the number of loans granted in a given period or the number of outstanding loans, where this data is made available. Access, in contrast, can be more difficult to gauge. Many more people may have access to a product than those who choose to use it. Thus it is important to assess the extent to which usage or take-up of these products by targeted borrowers reflects their unconstrained choice or whether borrowers face other barriers that prevent them from accessing these products. Such barriers may include affordability constraints, limited borrower awareness, or a shortage of mortgageable housing stock.

In order to quantify access levels, information is required on the characteristics of the target market as well as on the features and credit-granting criteria associated with recently launched mortgage products. Together, this information will provide the basis for determining their potential market reach. It will also help to identify barriers that may impede greater access. The purpose of this paper is to present the findings of a data gathering exercise, limited to bank-provided mortgage products, targeting the low income market.

To create a picture of demand conditions, a number of data sources have been used. These include the FinScope™ 2005 and 2004 surveys, the 2004 Labour Force Survey, the 2004 General Household Survey, the 2003 NHFC End-User Survey and the 2005 All Media and

---

<sup>2</sup> While this is CPIX adjusted each year from base year October 2003, this paper uses these absolute figures as the basis for the analysis.

<sup>3</sup> In 2006, the Banking Association announced that banks had disbursed R17 billion of housing finance to the target market from the beginning of January 2004 to the end of September 2005. R11 billion was in the form of mortgage loans (65%), R4.8 billion was in the form of pension-backed loans while the balance (R12 billion) was in small loans and loans to developers.

Products Survey (AMPS). The analysis of this data yields estimates of the size and characteristics of the target market, measured both in terms of individuals and households. It also probes attitudes to housing as well as access to housing finance.

On the supply side, various mortgage and other housing finance lenders were interviewed in order to obtain data relating to product features as well as the minimum borrower and property criteria for various types of loans. Lenders were asked about their perceptions of the key challenges and opportunities facing the housing finance sector. And representatives of key supporting institutions were interviewed as part of this study. A list of interviewees is attached in Appendix A.

## THE TARGET MARKET

The income parameters used to define the low income market in this report are based on the FSC target market definition: households with a monthly income of between R1 500 and R7 500. Based on various surveys it appears that the target market comprises around four million households<sup>4</sup> and 12 million adults aged 16 or more<sup>5</sup>.

Table 1: Size of the target market

	Number of households	Overcount (-) / Undercount	Best estimate
<b>AMPS 2005</b> (R1,399 - R7,999)	4,952,259	-535,669	4,416,590
<b>LFS 2004</b> (wage income only)	3,346,327	669,265	4,105,593
<b>GHS 2004</b> (wage and grant income only)	3,281,140	492,171	3,773,311

	Number of adults (16+)	Overcount (-) / Undercount	Best estimate
<b>AMPS 2005</b> (R1,399 - R7 999)	14,225,753	-1,551,651	12,674,102
<b>FinScope 2005</b> (R1,500 - R7,999)	11,918,392	-127,499	11,790,893

At the outset, it is important to note that the estimate of target market size is based on the dwelling-based definition<sup>6</sup> of the household unit used in most household surveys. This definition may not coincide with the financial or risk household, nor does it necessarily imply permanence. According to the LFS 10% of households in the target market have other dwellings aside from their main dwelling. In addition, where household composition is a function of the lack of housing and access to housing finance, this definition is likely to misrepresent the number of potential households in the target market. According to the 2003

<sup>4</sup> The only current household survey that provides household income data is AMPS. However, that survey undercounts the number of households in South Africa significantly. In addition, the income segments for AMPS do not correspond to the FSC target market. The closest income parameters provided by the survey are R1 400 and R7 999 resulting in an overestimate of the market size. The AMPS estimate has therefore been adjusted downwards. Household income is not provided in the LFS or the GHS. In those surveys the calculation of household income has been based on disclosed wage income only in the case of the LFS and wage income plus grants in the case of the GHS. Other sources of income such as remittances, private pensions, rentals and investment income are not included. An analysis of income components in the target market using the 2000 Income and Expenditure Survey indicates that salaries and grants are the primary income sources although it is estimated that the market size will be understated by between 15% (GHS) and 20% (LFS). Estimates of the size of the target market provided in the table have been factored up accordingly. However, data from the LFS or the GHS on the nature of dwellings or other household conditions presented in this report is not factored up. It should also be noted that population weights used in the GHS are based on the 1996 census while weights for the LFS are based on the 2001 Census.

<sup>5</sup> As noted above, income categories in AMPS do not correspond with the FSC target market parameters. Likewise, FinScope does not provide an income banding at R7 500. The closest band is the R7 000 – R7 999 band. Thus, estimates have been adjusted for those earning between R7 500 and R7 999 (assuming a uniform distribution of adults across the income band).

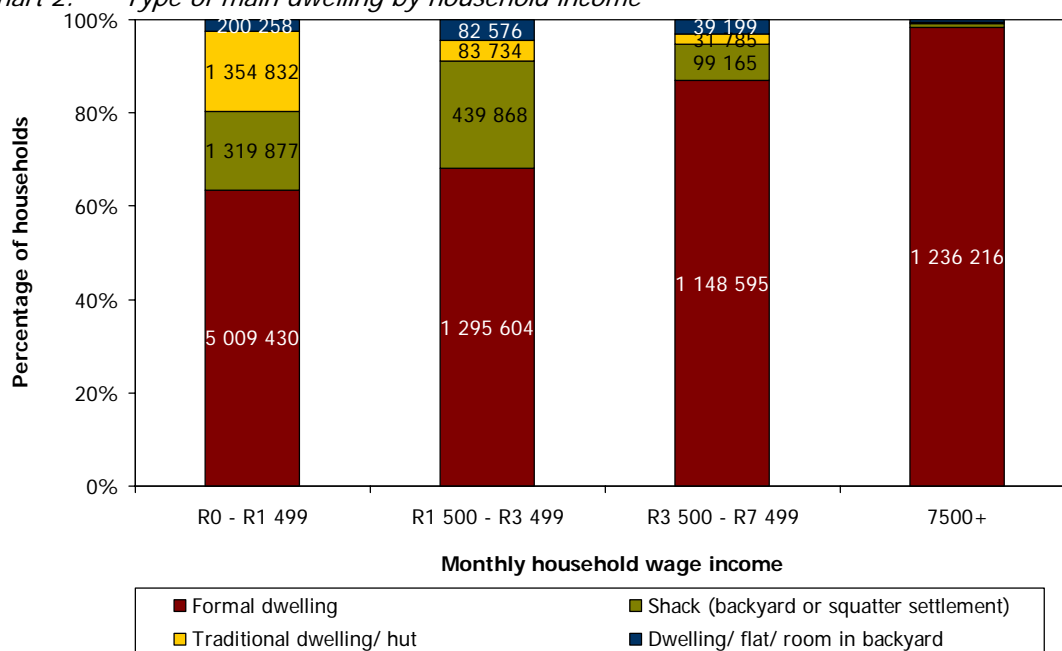
<sup>6</sup> According to Stats SA "A household is defined as a person or group of persons who occupy a common dwelling unit (or part of it) for at least four days per week on average during the past four weeks prior to the survey interview. Basically they live together and share resources as a unit. Other explanatory phrases can be 'eating from the same pot' and 'cook and eat together'". According to AMPS "A household consists either of one person living alone or a group of persons usually but not always members of one family who live together and whose expenditure on food and other household items is jointly managed. Boarders or lodgers may be included as household members, provided that they have at least one main meal a day communally. Resident domestic workers are however excluded and regarded as forming a household of one or more persons in their own right"

NHFC End-User Survey, existing dwelling-based households in the target market contain on average 1.8 potential households. Clearly, where the existing household contains more than one potential household, the household income descriptor is inaccurate as are the estimates of the size of the market. In the absence of alternative data sources, findings reported in this document should therefore be regarded as 'best estimates' rather than as definitive.

***The need for housing and housing finance in the target market***

According to FinScope™, approximately 20% of those aged 16 or more in the target market (or 2.4 million of the 12 million adults in the target market) live in informal dwellings<sup>7</sup>. According to the LFS, 16% of main dwellings within the target market are shacks, corresponding to 540 000 units, while a further 122 000 (4%) are backyard dwellings. There are also 115 000 households living in traditional huts or structures (3% of main dwellings in the target market). While these are typically not included in the calculation of the housing backlog, it is likely that many require significant upgrading. Almost 80% of informal dwellings are occupied by lower-income households within the target market (households with an income of less than R3 500 per month).

Chart 2. *Type of main dwelling by household income*



Source: LFS 2004

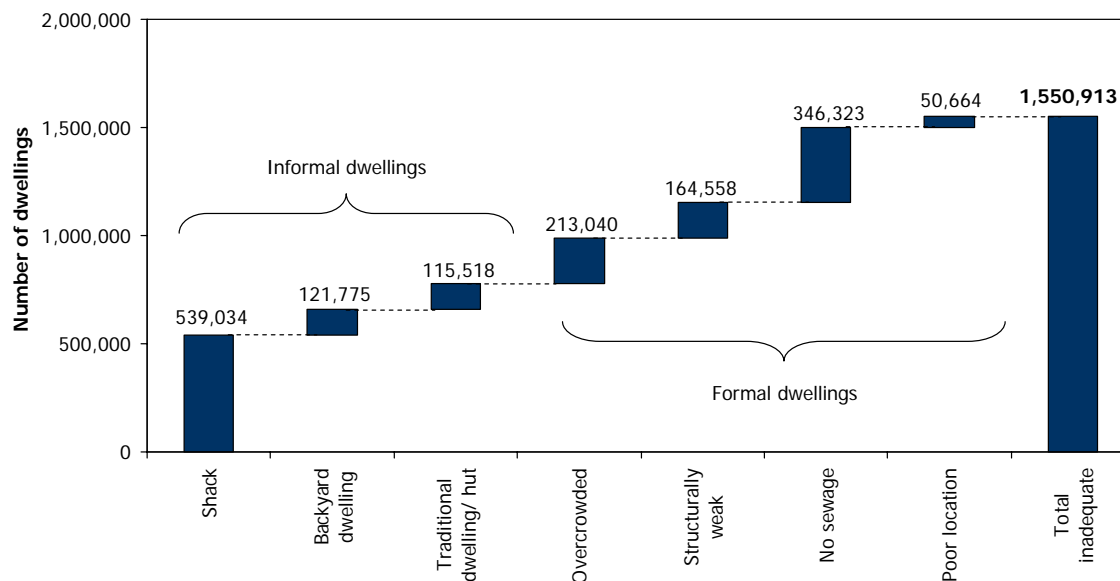
Aside from informal dwellings, many of the 2.4 million formal main dwellings in the target market also appear to be inadequate. The LFS indicates that 213 000 formal dwellings are overcrowded<sup>8</sup> while 200 000 are structurally weak. In addition, many dwellings lack access to basic services. 19% of formal dwellings (460 000 units) occupied by the target market rely on

<sup>7</sup> Source: FinScope™ 2005. Informal dwellings include backyard outbuildings, garages, back rooms, shacks or huts.

<sup>8</sup> A dwelling is considered to be overcrowded if it contains more than 2 people per room

pit latrines, bucket toilets or have no toilet facilities, while 7% are poorly located (households are located 45 minutes or more away from a clinic, school or food market, using their usual form of transport). While solutions to these deficiencies are not strictly speaking within the housing realm, lack of services or proximate facilities often precipitate the search for alternative accommodation and thus have an impact on the demand for housing.

Chart 3. *Inadequate housing in the target market (Household income of R1 500 – R7 500)<sup>9</sup>*



Source: LFS 2004

As with informal dwellings, the majority of inadequate formal dwellings are occupied by households with a monthly income of less than R3 500 (in this case, two thirds of inadequate formal dwellings are occupied by this sub-segment of the target market).

**Using only households in shacks, backyard dwellings and overcrowded formal dwellings to proxy housing need, over 870 000 dwellings are required by the target market.**

Aside from dwelling characteristics identified above, the need for housing in the short to medium term will also be affected by factors such as growth in the number of households<sup>10</sup> arising from demographic factors rather than the alleviation of overcrowding, as well as

<sup>9</sup> Note these categories are mutually exclusive. There is no double counting.

<sup>10</sup> It appears that the number of households in South Africa is growing faster than the population as a whole. According to the Census 2001 there were 11.8 million households in South Africa while the 2004 LFS finds a total of 12.6 million resulting in a compound annual growth rate of 2.3% over the period. Using the same data sources the population appears to have grown by 1.3% per annum over the same time period.

migration patterns that increase the demand for housing in specific areas, most notably in Gauteng and the Western Cape<sup>11</sup>.

It should be noted that demand for housing arises not only, and not always, in response to the inadequacy of existing dwellings. Just as those in upper income markets buy and sell houses through the course of their lives, so too should households in the target market be able to adjust their housing situation to suit their circumstances. Likewise, households that are deemed to have inadequate dwellings may prefer to maintain their current accommodation rather than invest additional resources to upgrade or relocate. In terms of assessing access, the analysis is therefore not restricted to the subset of households that are currently inadequately housed. Rather, all households in the target market identified by the FSC are considered potential candidates for a mortgage.

### ***Other characteristics of the target market***

A review of other household characteristics, aside those relating to their dwellings, can provide further insight into both the range of housing finance solutions required by the target market as well as the financial and risk profile of that market.

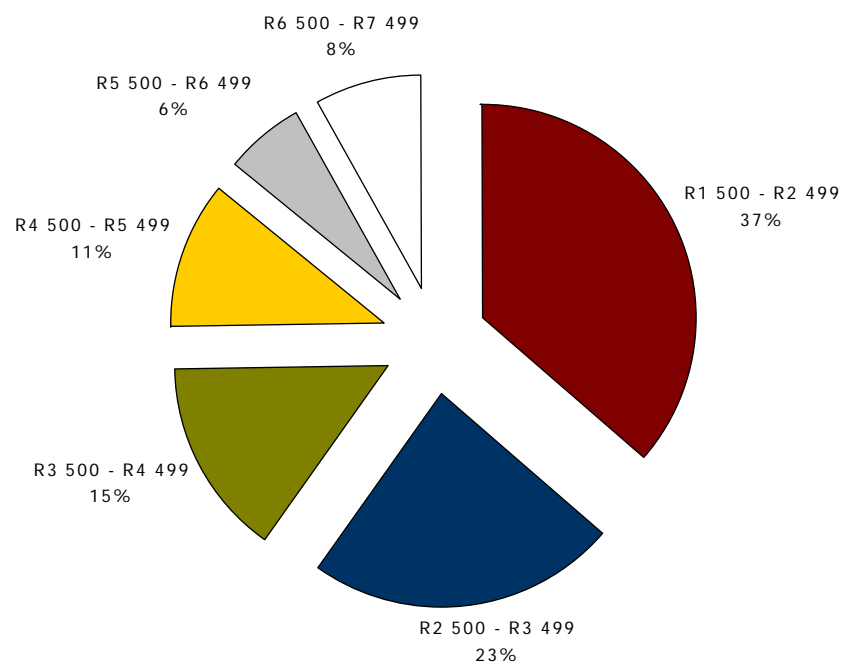
#### *Income and income sources*

According to the LFS, 37% of households in the target market have a monthly income of less than R2 500 while a further 22% earn between R2 500 and R3 500 per month. Households in this income bracket who have not previously owned a house qualify for a housing subsidy of around R32 000.

---

<sup>11</sup> According to Stats SA's midyear population estimates published in September 2005 Gauteng will experience a net migration over the period 2001 – 2006 of 519,900 while net migration into the Western Cape will be 224,400.

Chart 4. Distribution of households by income



Source: LFS 2004

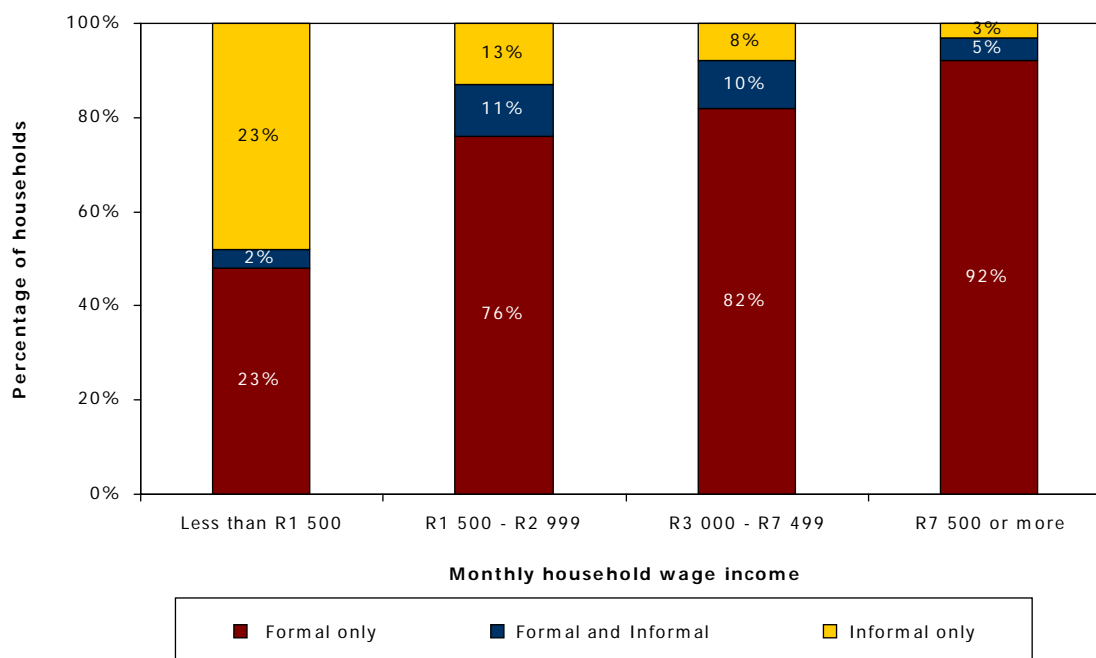
Even with a housing subsidy, poorer households in the target market may not be able to afford the purchase of a home if house prices and building costs continue to rise. They may therefore require shorter term, smaller loans to enable them to improve their dwellings incrementally.

Table 2: Maximum installments and corresponding loan values for a 20-year mortgage at 12.5%, using 30% as an affordability cut-off

Monthly household income	Maximum affordable installment	Maximum bond amount	Capital subsidy	Maximum house value
R1 500	R 450	R40 020	R32 000	R72 020
R2 500	R 750	R66 701	R32 000	R98 701
R3 500	R1 050	R93 381	R29 500	R122 881
R4 500	R1 350	R120 061		R120 061
R5 500	R1 650	R146 741		R146 741
R6 500	R1 950	R173 422		R173 422
R7 500	R2 250	R200 102		R200 102

Income sources differ in the target market. While only 8% of more affluent households generate wage income in the informal sector, informal sector earnings contribute to household wage income in around 20% of households in the target market. Aside from being difficult to verify, such earnings are often sporadic.

Chart 5. Income sources by monthly household wage income



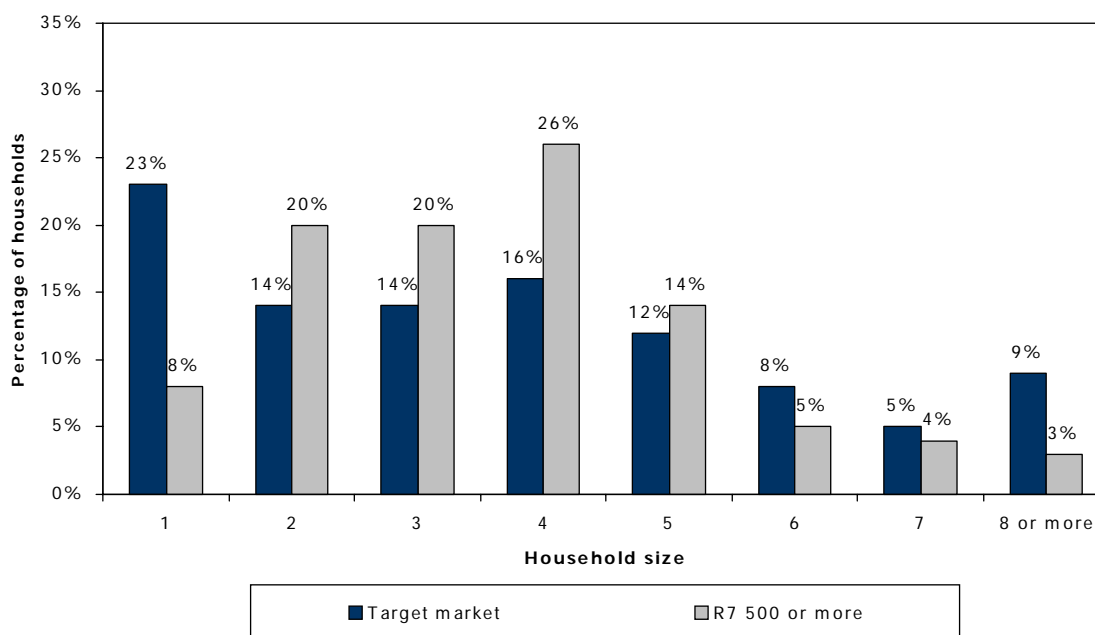
Source: LFS 2004

#### Household size and composition

The size of households differs noticeably in the target market from those in higher income segments. Lower-income households are more likely to comprise either one member<sup>12</sup> or six or more members.

<sup>12</sup> 89% of single member households in the target market consist of males. Single member households are more likely to make payments to family members outside the household than other households (60% of single member households compared to 33% of all households). Interestingly, only a tiny proportion of these single member households regard themselves as having other dwellings. Also of note is that almost 40% of single member households occupy their dwellings rent-free as part of an employment contract while a further 40% rent their dwellings. Only 18% claim to own their dwellings compared to 70% of multiple member dwellings.

Chart 6. Household size

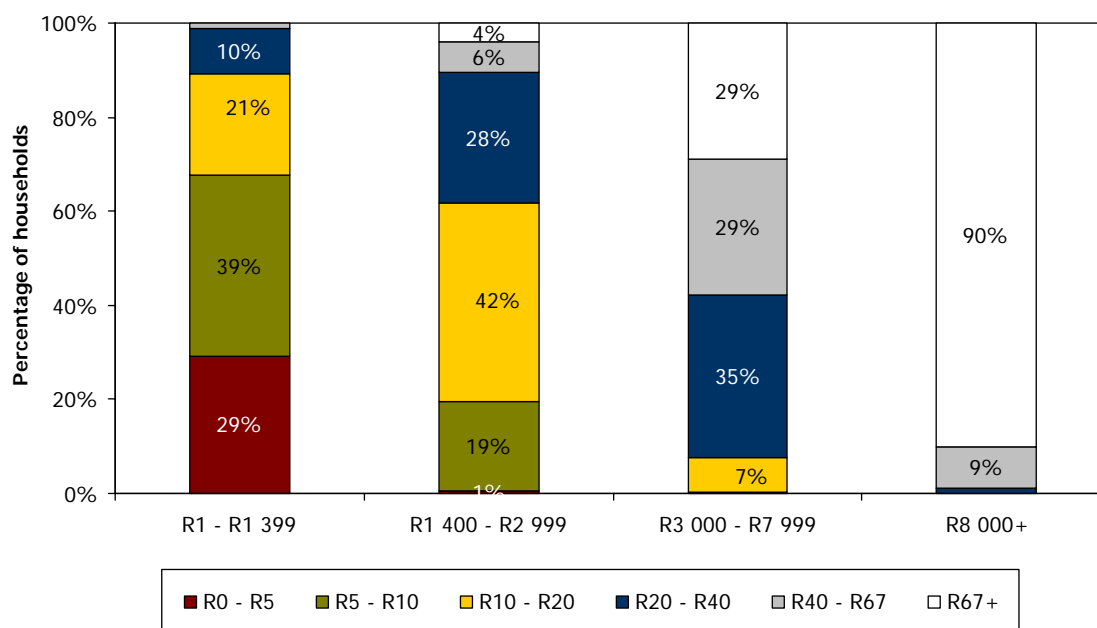


Source: GHS 2004

Aside from impacting on the type of housing required, household size and composition will also impact on the financial profile of the household. Holding other things constant, the size of the household has a direct impact on the wellbeing of its members as larger households have higher dependency ratios and lower per capita incomes. Data from AMPS indicates that 10% of households in the target market have a per capita income<sup>13</sup> of less than R10 per day while a further 25% have a per capita income of between R10 and R20 per day.

<sup>13</sup> Per capita income is calculated by dividing the midpoint of the household income band by the number of adult equivalents in the house. Children under 10 are considered to be half an adult. The per capita income cut off of R20 per day is based on an international norm of \$4 per day as a cut-off point to identify the poor.

Chart 7. Per capita income (Rands per day) by monthly household income



Source: AMPS 2005 RA

Research into financial risks that impact on lower-income households indicates that a change in the composition and size of the household has as much of an impact on the welfare of the household as a change in the income profile of the household head<sup>14</sup>. In addition, research into causes of mortgage default indicates that an increase in household size and the resultant higher household dependency ratio could be a significant contributing factor to a household's inability to meet its financial obligations<sup>15</sup>.

In terms of household composition, traditional nuclear family households are far less common in the target market than in higher income households, with a higher proportion of low income households containing extended family<sup>16</sup> or non-relatives (35% of the target market compared to 20% of higher income households). In these households, variability in the household's income profile is a function not only of income source but also of the relationship of the income earner to the household<sup>17</sup>.

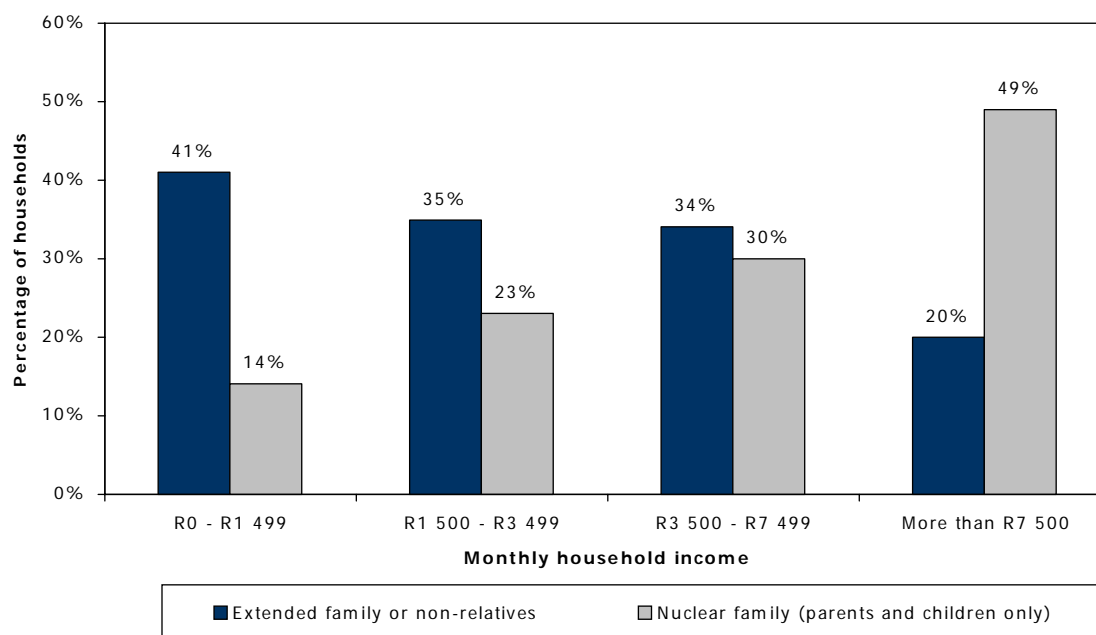
<sup>14</sup> Research into households that moved in and out of poverty in the period 1993 to 1998 showed that a quarter of households that were not poor in 1993 who moved into poverty by 1998 did so because of a demographic event. It also showed that 20% of households that moved out of poverty did so because of a demographic event. (Source: Leibbrandt as quoted in 'Household Formation, Poverty and Unemployment – The Case of Rural Households in South Africa' by S Keller, Stellenbosch Economic Working Paper 1/2004, University of Stellenbosch)

<sup>15</sup> Source: "Reasons for non-payment of mortgage loans and municipal services", NHFC, March 2003

<sup>16</sup> These households contain the following relatives to the head of the household: brothers or sisters, grandchildren or grandparents, other extended family or non-relatives.

<sup>17</sup> It is interesting to note that according to the GHS there are around 500 000 households in the target market that consist of traditional nuclear families (both parents and children only) that could repay a loan before retirement. This corresponds to 16% of the target market.

Chart 8. Household composition



Source: GHS 2004

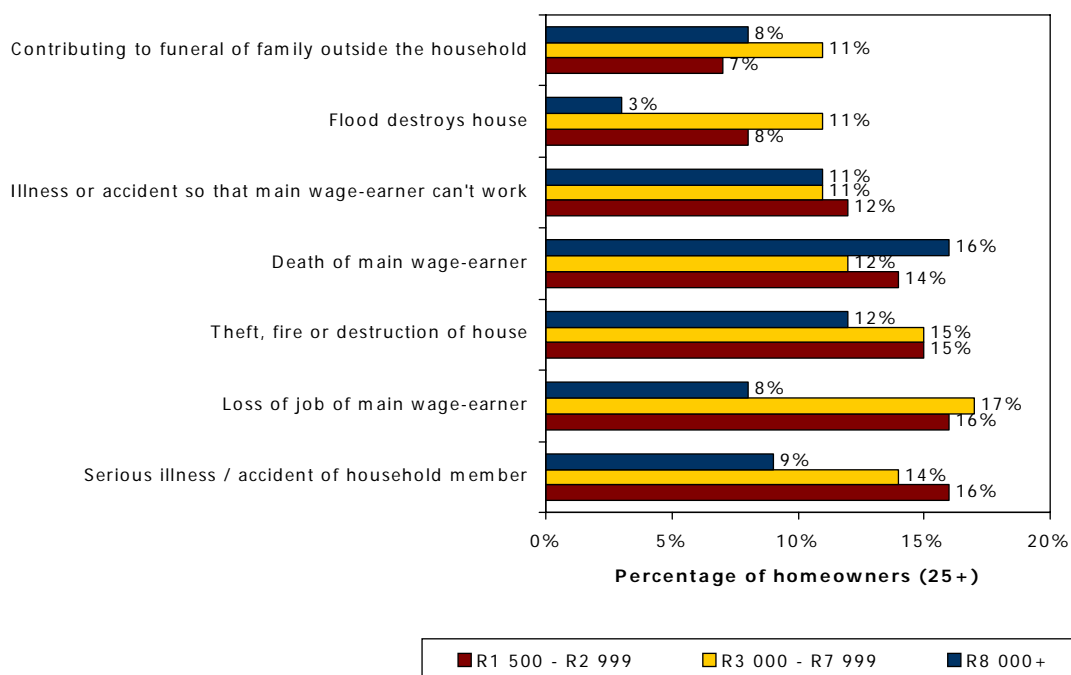
Financial co-dependence between households is also common in the target market. Just over one third of households in the target market make payments to relatives who live outside the household<sup>18</sup>. The existence of inter-household financial linkages obviously complicates the assessment of a household's capacity to repay installments as well as the household's exposure to financial risks, some of which may be generated outside the household.

*Exposure to, and ability to absorb, financial shocks*

Lower-income households appear to face a higher probability of experiencing financial shocks. FinScope™ contains questions relating to the household's perception of the likelihood of risk events. The data indicates that households in the target market perceive themselves to be at greater risk of loss of a wage earner's job or accidents or illness of household members.

<sup>18</sup> Source: LFS 2004.

Chart 9. Risks that are likely to happen by monthly household income

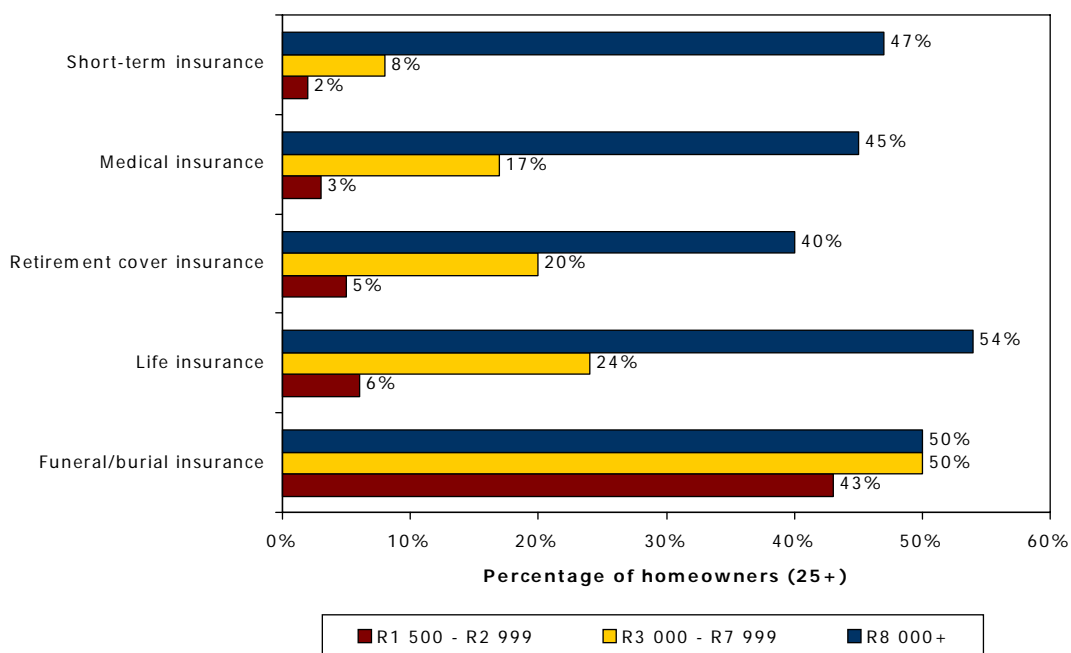


Source: FinScope™ 2005

In addition, risks associated with HIV/AIDS are higher in the lower-income market, particularly for those of income-generating age.

Ownership of insurance and savings products provides households with the capacity to absorb financial shocks should they occur. Data from FinScope™ indicates that, aside from funeral insurance, a minority of individuals in the target market use long and short-term insurance products. Household usage of medical aid is also rare. This is partly a function of the nature of employment contracts and benefits provided by employers to workers in the target market and partly a function of historically poor levels of access to financial products for lower income individuals in South Africa.

Chart 10. Ownership of insurance products: Adults aged 25 or more

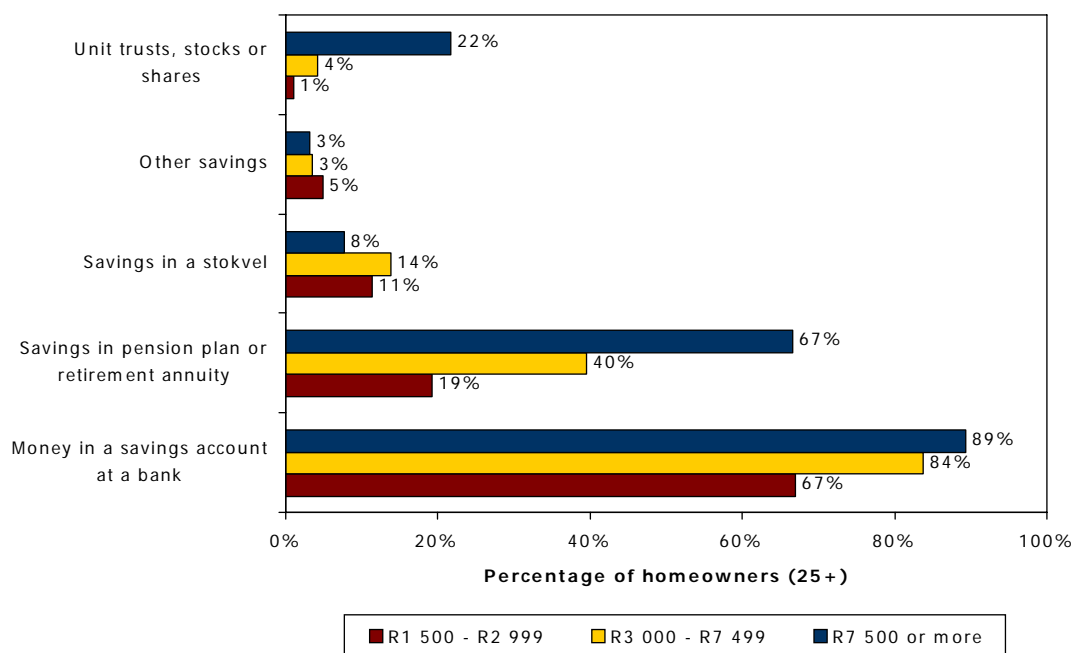


Source: FinScope™ 2005

Data from FinScope™ indicates that around half the target market aged 25 or more is not engaged in any savings or investment activity<sup>19</sup>. Household data from the LFS confirms that, while many households have money in a bank savings account, relatively few have other savings products. Note that no indication is provided by any survey on the quantum of funds saved.

<sup>19</sup> The comparative percentage for higher income individuals is 25%

Chart 11. Does the household have ..? By monthly household wage income



Source: LFS 2004

**Summary**

The analysis of households in the target market demonstrates that the housing need in the target market is significant, as is, by extension, the need for housing finance given the large investment typically required to purchase or upgrade a house. The analysis also shows that there is significant diversity within the market, in terms of financial wellbeing and exposure to risk. These characteristics will play an important part in determining how many households in the target market will have access to existing mortgage products. As noted in the introduction to this report, not all households that would otherwise have access to a mortgage will choose to use one. Some households may prioritise other non-housing expenditure or investment while others may prefer alternatives to home ownership. For those who choose to invest in improving their housing situation, a range of financing solutions is required to allow for the upgrading or enlargement of existing dwellings and the purchase of existing or newly developed dwellings.

## SUPPLY OF MORTGAGE PRODUCTS IN THE LOW INCOME MARKET

A number of banks have begun to offer home loans in the FSC target market - households with a monthly income of between R1 500 and R7 500.

### [Absa announces home loan financing for all](#)

*Absa has introduced a new home loan product that makes it possible for almost anyone to own a home of their own! MyHome, gives individuals or couples with joint monthly incomes of between R1500 and R7 500, access to an affordable 100% mortgage bond that can also include a five-year fixed-rate option.*

*"It is completely unique concept in that the qualifying criterion is based primarily on proof of regular income. This means that applicants do not have to be formally employed to be granted a home loan... In addition to offering our clients 100% bonds, an additional 10% will also be included to cover transfer duty, bank fees and registration costs... "If applicants cannot prove regular income or permanent employment, then Absa will help them establish financial track records with Absa TargetSave Accounts," Opperman says.*

*Qualifying for an Absa MyHome home loan is simple: Applicants must be over 21 years of age, be in possession of a South African Identity document and show proof of regular monthly income of between R1 500 and R 7 500 either as a single or joint income.*

Standard Bank's [DreamStart](#) product is also available:

*DreamStart is a home loan aimed at making home finance more accessible to low income earners. That is, those earning a single or joint income of between R1 500 and R6 000 a month, excluding housing subsidies or allowances.*

*You can apply for a DreamStart home loan if: (1) You earn a joint income of between R1 500 and R6 000 a month and want to buy a home (2) You are building a new home (3) You are looking to move to a bigger or better home*

FNB's product is known as [SmartBond](#).

*FNB has diversified its product portfolio to include a home loan called SmartBond. The offering aims to be inclusive by also serving the target market as defined by the Financial Sector Charter. SmartBond is designed for people earning a single or joint gross monthly income of between R2 500 and R10 000.*

*Over and above easy access to a home loan, other key distinguishing SmartBond features include:*

- *A 5-year fixed rate resulting in fixed monthly instalments*
- *Affordable life insurance with no medical check required*
- *Full loan amount plus bond costs*

*"FNB believes that broadening access to credit will not only increase the quality of life for ordinary South Africans, but also create tremendous opportunities for residential development - boosting the country's urban housing scene by enabling the development of properly planned and quality suburbs," says Marais.*

*"Through owning property, more people will be able to grow their personal wealth. Property ownership is virtually a risk-free investment, so it's a secure form of saving." "Wealth creation for a broader base of South Africans is vital for the growth of the economy," Marais concludes.*

At the same time, other lenders also offer mortgage products: the National Housing Finance Corporation has a number of clients in its Home Ownership Division that offer mortgage loans to households earning less than R7500 per month. These include the Mpumalanga Housing Finance Company, Ithala Limited, Beehive, Masakeni Credit Corporation, Real People Housing, and Greenstart Home Loans (Pty) Ltd.

### ***Product features of home loans in the low income market***

#### *Interest rate*

The interest rate associated with low income mortgage loans is typically higher than rates offered to higher income mortgagees<sup>20</sup>. This reflects higher perceived risks associated with the target market including higher default risk, increased risks of loss given default, as well as the proportionately higher burden of costs given low loan values. On the other hand, prepayment and relocation risk, a significant source of risk in higher income markets is likely to be minimal in the target market. However, without an extensive review of loan repayment patterns it is not possible to assess the relative magnitude of various risks and their impact on loan pricing. Likewise the absence of detailed data on loan unit costs makes it difficult to assess cost loadings.

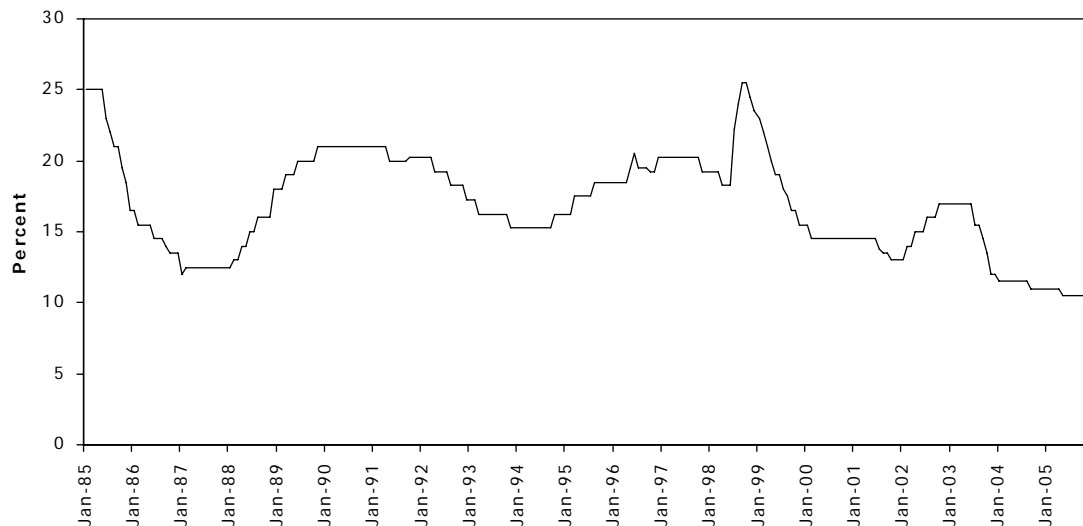
---

<sup>20</sup> Prime less one quarter of a percentage point is the lowest interest rate offered in the low income market compared to prime less two percentage points available for higher-income borrowers.

*Fixed or variable rates*

Prime rate to which most mortgage bonds are linked, has varied significantly over the past 20 years and has reached a twenty year low of 10.5%<sup>21</sup>.

Chart 12. Nominal prime overdraft rate: 1985 - 2005



Source: SARB

Fixed interest rate mortgages are available from some lenders while others have developed mortgages with a combination of fixed and variable rates. This product dimension is thought to be important particularly for lower-income households, as fixed interest rate products generate stable and predictable installments, albeit at a cost<sup>22</sup>. Research also indicates that a sizeable segment of the target market would prefer a fixed interest rate product<sup>23</sup>.

<sup>21</sup> The installment on a R100 000 bond at 10.5% is R990. If the prime rate were to increase to 17% (prime rate in 2003) the installment would increase by over R450 per month.

<sup>22</sup> Various mechanisms exist to manage the impact of fluctuation interest rates on the borrower. Not all these mechanisms are available in South Africa:

- Fixed interest rates: A number of low income mortgage lenders offer borrowers fixed interest rate mortgage products. Typically lenders increase the interest rate to compensate them for bearing the risk of an increase in interest rates during the life of the loan as well as the risk of early repayment should interest rates fall. Examples include the Mpumalanga Housing Finance Company which offers fixed rate loans at 16% for all mortgage loans.
- Convertible adjustable rate: These loans enable borrowers to switch to a fixed rate for a given period at any stage in the life of the loan. ABSA and FNB offer a five year fixed rate option which in ABSA's case is typically two percentage points above the variable rate while Standard Bank offers the option of fixing installments for a period of 24 months at one percentage point above base rate.
- Negative amortization / fixed installments: Negative amortisation occurs when the installment is not large enough to meet the interest portion of the loan repayment. The unpaid interest (or deferred interest) is added to the loan amount. Where installments are fixed any difference between the installment and interest portion of the loan is added to the capital amount to be repaid during the loan term. Clearly, where the loan liability increases to such an extent that it exceeds the value of the property, the risk of default increases. Variable term loans that enable borrowers to maintain installment levels if interest rates rise are available for pension-backed loans. When interest rates increase the installment is held constant and the loan term is increased.

However, it should be noted that fixing interest rates on home loans does not mitigate other key risks associated with a higher interest rate environment, such as company closures or retrenchment that lead to job losses and by extension, to default. Arguably, these risks are more significant drivers of default than fluctuating installments.

#### *Product term*

Some researchers have questioned whether long-term credit products are appropriate for the low income market. However, while the probability of a cash flow disruption or an interest rate increase during the life of a loan increases with the term of the product, so too does the affordability of the installment (for a fixed capital amount, the longer the term of the loan the smaller the monthly installment). Clearly, the stability of the economic environment will determine which of these countervailing forces will dominate<sup>24</sup>.

While the banks typically offer 20-year products (with early repayment options), other low income mortgage lenders offer products with terms of five (Mpumalanga Housing Finance Company), eight (Greenstart), 12 (Beehive) or 18 years (Mpumalanga Housing Finance Company).

#### *Size of the loan*

Small loan sizes (for some lenders as low as R20 000) are available for this market. However, given the relatively high costs associated with registering a bond, mortgage finance is not necessarily the most efficient option for smaller capital amounts. According to some lenders the minimum loan size at which a mortgage becomes viable is around R45 000. Assuming that 30% of household income can be allocated to bond repayments and that the mortgage is financed at prime rate (currently 10.5%) this translates into a minimum monthly income requirement of R1 500<sup>25</sup>, the lower bound of the FSC target market definition, implying that theoretically, mortgage finance is affordable to all households in the target market<sup>26</sup>.

- 
- Interest rate caps: Some lenders provide an insurance product that limits increases in interest rates enabling customers to minimise exposure to interest rate increases while maintaining the upside if interest rates decrease. It appears that this feature is not currently available for low income borrowers.
  - Balloon loans: These loans are short term fixed rate loans (typically three, five or seven years) based on a repayment pattern of a 20 or 30 year loan with a lump sum payment required at the end of the term. This lump sum is typically financed through borrower savings or through a re-mortgage. These loans are not yet available in South Africa

<sup>23</sup> The 2003 NHFC End-user Survey found that 58% of potential home purchasers in the target market would prefer a fixed rate product. It is not clear whether survey respondents were provided with a price trade-off. More recent research conducted by the Banking Association found that borrowers were in general prepared to pay more for a fixed rate product.

<sup>24</sup> Aside from risk and affordability-related considerations, other factors may bias some segments of the market towards shorter-term products. Older borrowers, for instance, may not qualify for a 20-year loan.

<sup>25</sup> Based on a term of 20 years. This generates an installment of R445 per month. It should be noted that if the household can only obtain a mortgage at rates above prime rate (currently 10.5%), the amount of the loan will be somewhat diminished.

<sup>26</sup> Households earning less than R3 500 per month are eligible for the housing subsidy which currently equals about R32 000 for households earning up to R1500 and R29 500 for households earning up to R3500. Added to a R45 000

*Readvance (access bond) facility*

Low income borrowers, like more affluent borrowers, may require additional finance during the term of the loan. Many lenders will readvance capital repaid during the life of the loan. Some lenders limit readvances to any excess capital payments made while others will provide access to the full capital amount on special application.

*Deposit and loan-to-value ratios*

Where sufficient savings are available, mortgage lenders typically require borrowers to provide a deposit (usually between 10% and 20% of the value of the loan) and pay registration and transfer costs associated with the bond. For those households that cannot provide a deposit, various options are available:

- Deposit subsidies: In 2005, Minister Sisulu announced the introduction of State-funded, credit-linked subsidies for households with an income of R3 501 to R7 500 per month who qualify for credit from commercial lenders. While the subsidy hasn't actually been launched yet, it is intended that lenders will receive applications for these subsidies and process them on behalf of the State as part of the process of granting housing finance loans. Aside from the State, employers may provide deposits.
- Commercial risk insurance: The HLGIC provides lenders with five-year commercial risk cover on loans to low income borrowers<sup>27</sup> who do not have sufficient collateral or a deposit. Lenders purchase this insurance from the HLGIC and the premium is capitalized into the loan at inception. In the event of default and if there is loss at a sale of the property in execution, the lender may claim up to the value of the guarantee issued. To qualify, borrowers must attend an HLGIC approved education course on home ownership and mortgage finance.

The HLGIC first introduced a variant of this product 15 years ago. The product is now offered by three of the four retail banks as well as by some non-bank lenders. There has been significant growth in take-up of the product over the past three years as indicated below.

---

mortgage, this suggests affordability for a housing product of about R77 000 assuming that the mortgage can be financed at prime (10.5%).

<sup>27</sup> Borrowers who earn less than R7 500 per month

Table 3: HLGC Commercial Risk Insurance

	2003 - 2004	2004 - 2005	6m to end 2005	Annualised 2005 - 2006	CAGR
Number of guarantees provided	2,046	3,653	2,294	4,588	50%
Average loan size	85,982	92,026	103,090	103,090	9%
Average property value	86,954	92,597	105,404	105,404	10%
Value of loans extended with guarantees	175,919,172	336,170,978	236,488,460	472,976,920	64%

Source: HLGC

Aside from the HLGC, employers may provide guarantees. If suitable collateral or insurance is in place, mortgage lenders frequently assist households to cover costs associated with registering a bond. As a result, loan-to-value ratios can, and often do, exceed 100% and in some cases can be as high as 110%. High loan-to-value ratios are associated with higher default risk, as borrowers have a relatively small personal investment and the financial consequences of default for the borrower are consequently limited. In addition, there is the risk of negative equity if house prices should fall.

#### *Insurance riders*

Credit life and permanent disability insurance are mandatory (if a suitable policy already exists, this can be ceded to the lender). Life insurance premiums are usually level-term, paid monthly as part of the loan installment. If the borrower dies during the term of the loan, the full loan amount is paid off and any remaining balance is paid into the estate. Disability insurance may include temporary insurance, typically covering installments for up to six months. Less common, although still available, voluntary retrenchment insurance, paying up to six installments, is offered by some lenders<sup>28</sup>, although this tends to be expensive and take-up is reported to be low.

The HLGC has recently developed an insurance product covering default arising from HIV / AIDS-related illnesses. The product encourages borrowers to undergo voluntary testing for HIV / AIDS. If borrowers are HIV positive or become HIV positive during the term of the mortgage, they are enrolled on a treatment programme. This product will be introduced by a number of lenders in the near future.

<sup>28</sup> Standard Bank offers voluntary retrenchment insurance.

### *Payment flexibility*

Lenders typically allow early repayment, although some have levied a penalty if this occurs within a specified time period. Under the provisions of the new National Credit Bill, such penalties will no longer be allowed<sup>29</sup>.

In higher income segments, some lenders allow borrowers to take a payment holiday (suspend installment payments for a number of months) for those on maternity leave or other unpaid leave. However, this is not a standard product feature for mortgages in the low income market.

While not an advertised feature of the loan, both bank and non-bank lenders will accept partial payment if the household experiences financial difficulties. Typically, arrears management systems will flag any account that is not paid up and borrowers will be contacted immediately. Delinquent borrowers are encouraged to reschedule payments and foreclosure is instituted only when other options have been exhausted.

### *Borrower education*

Monthly bond installments can often be a household's single biggest expense. As noted in the analysis of demand conditions, their impact on the household budgets of those who have never owned a home (or who have previously owned a home but who have never used mortgage finance) can be significant, requiring household financial management techniques that borrowers might not yet have learned or experienced. Many lenders or loan guarantors therefore require borrowers to attend a formally structured borrower education course as a prerequisite to receiving a loan.

In South Africa, the best-known example of borrower education is the course offered by the Home Loan Guarantee Company ("HLGC"). This course covers various topics including: tenure, ways of acquiring a home, budgeting and affordability, consequences of default, impact of HIV-Aids, rights and duties associated with home ownership, subsidies (to the extent relevant) and insurance. In addition, the large banks as well as the Banking Association of South Africa have also created borrower education programmes.

### **Summary**

A summary of bank mortgage product features is provided below, followed by a summary of mortgage products provided by three non-bank lenders.

---

<sup>29</sup> The Bill states: "At any time and without notice or penalty a consumer may prepay any amount owed to a creditor under a credit agreement" (Chapter 6, 126 of the National Credit Bill)

Table 4: Summary: Bank mortgages for the low income market

Bank	Standard Bank	ABSA	Nedbank	FNB
Product name	DreamStart	My Home	Nedbank home loan	Smart Bond
Income criteria	Single or joint monthly income of between R1 500 and R6 000	Single or joint monthly income of between R1 500 and R7 500 increasing by CPIX annually	Currently a minimum of R5 000 but under review to reduce the minimum requirement	Single or joint income of between R2,500 and R10,000
Income source	Regular income. At least one year stable employment. Self employment based on merit	Regular income. Will incorporate informal income sources as long as there is proof of regular income.	Proof of income is required	Regular income. Will incorporate informal income sources as long as there is proof of regular income.
Age criteria	Loan to be repaid in full before borrower retires	Loan to be repaid in full before borrower retires		Loan to be repaid in full before borrower retires
Maximum installment as percentage of income	Repayments (excluding insurance and assurance premiums) are not to exceed disposable income, or 30% of gross income (as assessed via the affordability calculator), whichever is the lesser	30% of gross income	Generally up to 30% but varies based on risk	30% of gross income
Interest rate	Variable rate linked to prime. Lowest rate is prime less 0.25%. Highest rate is prime +2%. Rate depends on risk Option of fixed rate for 24 months at 1 percentage point above base rate. Available at any time during the life of the loan.	Variable rate linked to prime. Rate varies from 10.5% (prime) upwards. Rate depends on risk Fixed rate offered for five years at 2 percentage points above base rate. Available at any time during the life of the loan	Variable rate linked to prime. Pricing is risk based and influenced by the size of and equity in the loan. Fixed rate for up to 5 years. Pricing is risk based and influenced by the size of and equity in the loan.	Variable rate linked to prime. Rate depends on risk. Interest rates of below prime are available depending on client's risk profile. Option of fixed rate for five years at any time. Typical premium of between 1 and 1.5 percentage points over variable rate.
Term	Typical term: 20 years Maximum term: 30 years	Typical term: 20 years Maximum term: 30 years	Typical term: 20 years Maximum term: 20 years	Typical term: 20 years Maximum term: 30 years
Loan size	Subject to affordability	Minimum: R20 000 Maximum: Based on affordability	Currently R100 000 but under review to reduce the minimum requirement Maximum: Based on affordability	Minimum: R20 000 Maximum: R240 000
Pre-payment and early settlement	Clients can contribute more than required instalment. Three months notice is required when bond is to be cancelled. If earlier, then notice interest is charged (subject to National Credit Bill)	Fast Forward feature enables clients to pay more than minimum monthly instalment. No early settlement penalty.	Can settle early. No penalties	Can settle early. 5 year minimum term (subject to National Credit Bill)
Readvance facility	Limited Access Bond facility available when loan balance reaches 100% of assessed value. Clients can only borrow pre-paid amounts.	Clients can borrow any pre-paid amounts	Yes, automatically granted	
Deposit and loan to value ratios	The loan to value (LTV) can be up to 100% provided that the bank's exposure is reduced to 80% by means of the following collateral being provided: employee housing/government guarantee; if no other forms of collateral is available, Home Loan Guarantee Company (HLGC) indemnity can be arranged Maximum loan to value of 103% for lower risk clients	No deposit is required. Third party guarantee is purchased and the premium can be added to the loan or paid in cash. Collateral insurance (underwritten by the HLGC) is available for the first five years Maximum loan to value is 110% (purchase price plus costs)	Deposit requirement determined on the merits of each application. Other collateral will be considered Maximum loan to value is 108%	No deposit is required. Employer guarantee or HLGC indemnity required if no deposit Maximum loan to value is 108%
Compulsory insurance	Credit life cover is mandatory. Home Loan Protection plan with death cover (based on outstanding balance of the loan) have a 2 year waiting period. HIV /AIDS is not excluded. Do not have the HLGC HIV/AIDS cover. Retrenchment and temporary disability cover is optional. Can cede existing policy. Home owners comprehensive insurance	Level term life cover comprising permanent and temporary disability cover and HIV/AIDS cover. Can cede existing policy. Temporary disability cover for up to 6 months. Home owners comprehensive insurance	Life cover is compulsory for loans up to R150 000 Home owners comprehensive insurance	Level term life cover including death cover (inclusive of HIV/AIDS) and permanent disability Home owners comprehensive insurance
Optional insurance products	Retrenchment and / or disability cover can be added to Home Loan Protection plan. Household contents insurance is available	Additional life and disability cover without medical Household contents insurance		Additional life and disability cover without medical Household contents insurance
Education	Education for all borrowers via outsourced or in house providers.	Borrower education course offered by HLGC is compulsory for first time buyers and individuals requiring collateral insurance	Currently under review.	Compulsory Borrower Education for first time buyers and those with commercial risk insurance from HLGC. Education is outsourced to the HLGC.
Collections	Debit order, payroll deduction, stop order	Debit order, payroll deduction, stop order	Debit order, payroll deduction, stop order	Debit order, payroll deduction, stop order

Table 5: Summary: Non-bank mortgages for the low income market

Lender	Beehive	Greenstart	Mpumalanga Housing Finance Company	Mpumalanga Housing Finance Company
Income criteria	Single or joint monthly income of less than R10 000	Single or joint monthly income of R1 750 – R7 500	Single or joint monthly income of R1 500 – R3 500	Single or joint monthly income of R3 500 - R7 000
Income source	Regular income. Mostly, although not exclusively, government employees	Regular income. Formal income only	Regular income	Regular income
Age criteria	Loan to be repaid in full before borrower retires	Loan to be repaid in full before borrower retires	Loan to be repaid in full before borrower retires	Loan to be repaid in full before borrower retires
Interest rate	Fixed rate: 17% p.a.	Variable rate linked to prime. No fixed rate option	Fixed rate: 16% p.a.	Fixed rate: 16% p.a.
Term	12 years	15 or 20 years (2 products)	5 years	18 years
Loan size	Subject to affordability. Minimum is R20 000, maximum is R150 000	Subject to affordability. Minimum is R30 000, maximum is R230 000	Subject to affordability. Minimum is R20 000, maximum is R36 000	Subject to affordability. Minimum is R20 000, maximum is R150 000
Deposit and loan to value ratios	No deposit necessary if sufficient collateral is in place (State guarantee or cession of pension fund)	10% deposit or collateral in the form of employer guarantee (20%)	5% deposit or collateral in the form of employer guarantee or HLGC collateral insurance (10% - 20%)	5% deposit or collateral in the form of employer guarantee or HLGC collateral insurance (10% - 20%)

## CREATING THE ACCESS FRONTIER FOR MORTGAGE FINANCE IN THE TARGET MARKET

As noted in the introductory comments, it is important to define the term 'access' and to distinguish between access and usage. Many more households may have access to a mortgage than those who currently use the product.

The access frontier methodology developed by Porteous (2005)<sup>30</sup> is a useful analytical tool for assessing levels of access to a particular product or service. The analysis generates a market map, comprising a number of market zones corresponding to various levels of access;

- *Current market*: This zone comprises those who currently have or use the product (who by definition have access to the product),
- *The market redistribution zone*: Those who are lie beyond the reach of the product because they are too poor lie in the *market redistribution zone*. Households in this zone will require non-market interventions such as subsidies to enable them to meet their housing needs.
- *The market enablement zone*: Those who are within reach of the market but who do not currently have the product lie in the market enablement zone. This zone can be further sub-segmented into those who actively choose not to have a product and therefore lie beyond the natural limits of the market and those who have not yet purchased the product but are candidates for doing so<sup>31</sup>.
- *The market development zone*: This zone comprises those who cannot access the product given their location or income profile and the product's current pricing structure but who are likely to be able to access the product in the near-term given the likely trajectory of product innovation and / or market dynamics.

By defining these market spaces, policymakers can clearly identify where markets can currently function, where they are soon likely to be able to function and where non-market interventions are required.

The application of this methodology to mortgage finance is complicated by the circular dependence of finance on the availability of the underlying housing asset. A pre-requisite for obtaining a mortgage loan is that there is indeed a house for the borrower to buy. Likewise, for most households, a pre-requisite for buying a home is that there is access to finance in

---

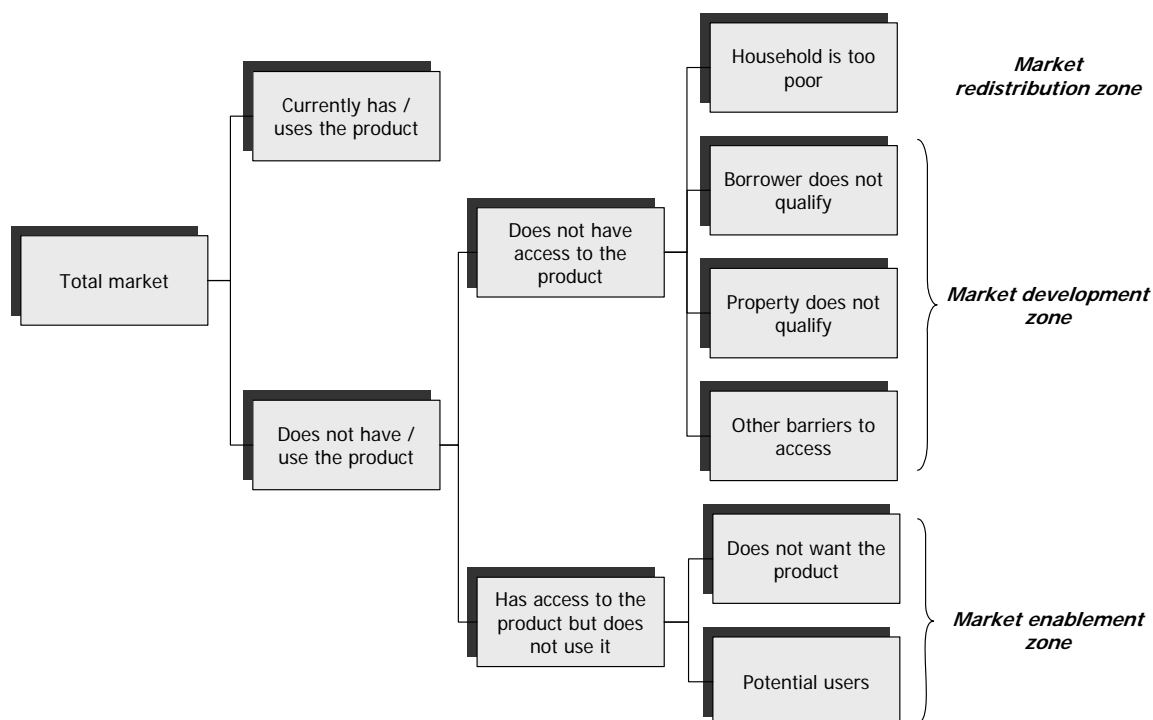
<sup>30</sup> This section is based on a paper by David Porteous entitled "The Access Frontier as an Approach and Tool in Making Markets Work for the Poor". In order to define the access frontier for housing finance, data on both supply (including qualifying criteria, distribution, product features and pricing structure) and demand (market size of those who satisfy supplier criteria and can access the product, reasons for non-use, etc.) are required. In addition, some indication of trends in both the market and production is required. These requirements formed the basis of the research agenda for the project.

<sup>31</sup> Reasons they do not have the product may include inertia or a lack of awareness. In the case of asset finance, a key factor constraining access may be the limited availability of the underlying asset. This is discussed in more detail in the next section of the document.

order to make such a large purchase affordable. Thus, despite the increase in the number of mortgage products targeting the low income market and the increased interest in low income mortgage provision by various product providers, if affordable housing units are not readily available to buy, real access to mortgage finance will not increase. Clearly if a potential borrower cannot find (or does not own<sup>32</sup>) an appropriate house he or she will not be able to secure mortgage finance. Thus potential borrowers who may otherwise qualify for a mortgage loan and who lie in what is termed the market enablement zone may be unable to access housing finance if they cannot find a suitable house.

While the access frontier methodology is therefore not easy to apply to mortgage finance, it nevertheless provides a useful analytical framework. The framework yields a segmentation of the target market that guides enquiry and analysis as illustrated below.

Chart 13. Access-based segmentation



Source: Based on “The Access Frontier as an Approach and Tool in Making Markets Work for the Poor” by David Porteous

This framework assumes that, while lenders may reject loan applications because the property does not meet their requirements, there is fundamentally no housing availability

<sup>32</sup> It is worth noting that some low income homeowners who wish to upgrade or leverage their existing housing assets may also require mortgage finance. Unlike homebuyers, access to mortgage products in this market segment is not curtailed by a housing stock shortage. Rather, factors such as awareness of potential borrowers about the availability and workings of mortgage products as well as an appreciation of the ability to leverage the asset value of their homes may limit effective access. Another key inhibitor in this market segment is the lack of formal title to property. Finally, the location and condition of the house may also not meet with lender requirements. Each of these constraints on access is dealt with in more detail in the body of this report.

constraint that prevents households from applying for a mortgage in the first instance. While this is clearly a simplification, it nevertheless enables a useful line of enquiry as it establishes the nature and magnitude of borrower-related access barriers and the extent to which mortgage products could support any additional housing supply that might be made available for the target market in the future.

### ***The current market for mortgage finance***

There is no reliable, recent source of data on mortgage use in the target market. While banks were asked to provide data on the value and volume of loans in their low income loan books, as well as the number of mortgage loans recently granted to the target market, none of the banks made this data available<sup>33</sup>.

Bank data supplied as part of the FSC process indicates that 100 000 loans were originated in the FSC target market between January 2004 and September 2005. However, no data is available on the total number of loans outstanding in this segment.

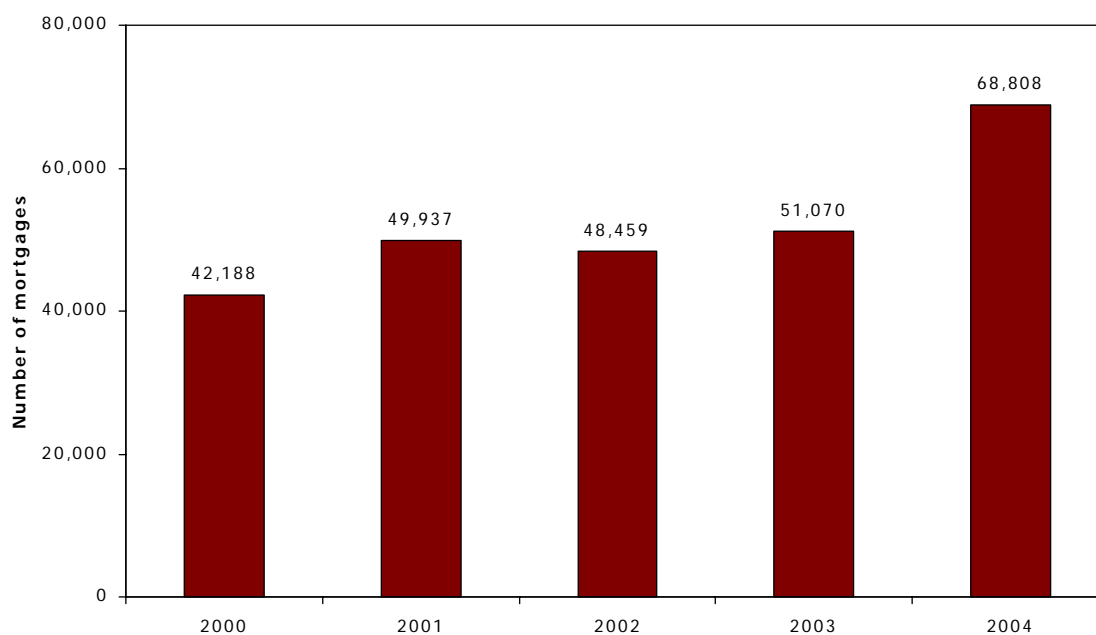
Deeds office data can provide an indication of lending activity in the target market, using affordability as a proxy to estimate household income. According to summarised deeds office data, presented as part of the recent BASA study on housing supply and functioning markets, over 260 000 mortgages were granted in the affordable housing segment<sup>34</sup> from the beginning of 2000 to the end of 2004. The cumulative value of these mortgages corresponds to R23 billion.

---

<sup>33</sup> Emails requesting the data were sent to each bank on February 23 followed up by a reminder on March 13. Two banks ignored the request for data. One bank indicated that such data is too sensitive to reveal while another indicated that such data was still to be audited.

<sup>34</sup> The definition of affordable houses are those whose value does not exceed R200 000 or those that are affordable to households earning between R2 500 and R7 500 per month.

Chart 14. Total mortgages in the affordable housing market

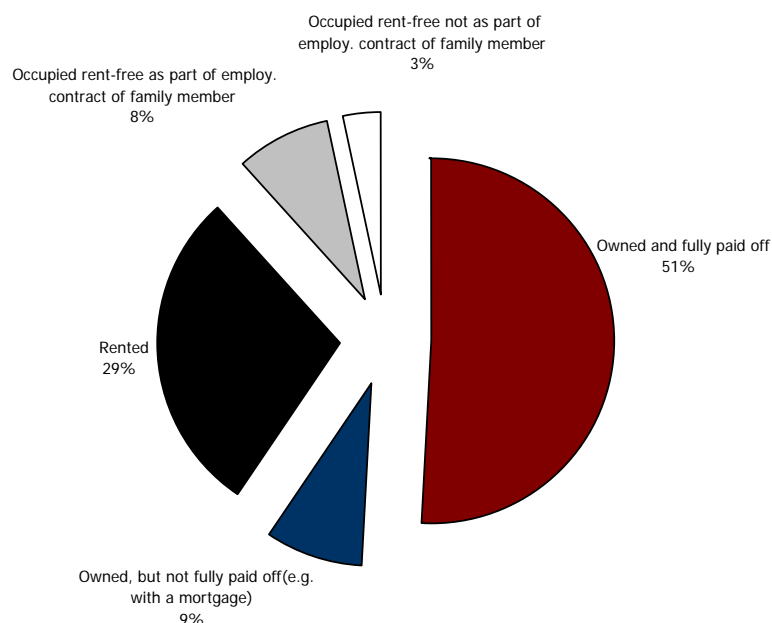


Source: Research into Housing Supply and Functioning Markets

Clearly the affordability proxy is imprecise, as the data will incorporate mortgages granted to those who lie outside the FSC target market but who have purchased a house deemed to be affordable to those within. In addition, no data is provided on the rates of prepayment of affordable mortgages. It is therefore not possible to assess whether the cumulative total of new loans granted over a five-year period is a good proxy for the number of households with mortgages in the affordable segment. Assuming that it is, and assuming that the target market comprises approximately four million households, this data indicates that 6.5% of households in the target market have a mortgage.

Surveys provide an alternative source of data on usage. According to the LFS, 60% of the target market own their homes; and the bulk of owned homes are fully paid off or were never financed to begin with. 9% of households in the target market or 284 000 households appear to have a housing loan in one form or another. No indication is available regarding the proportion of such loans that are mortgages.

Chart 15. Dwelling ownership: households in the target market



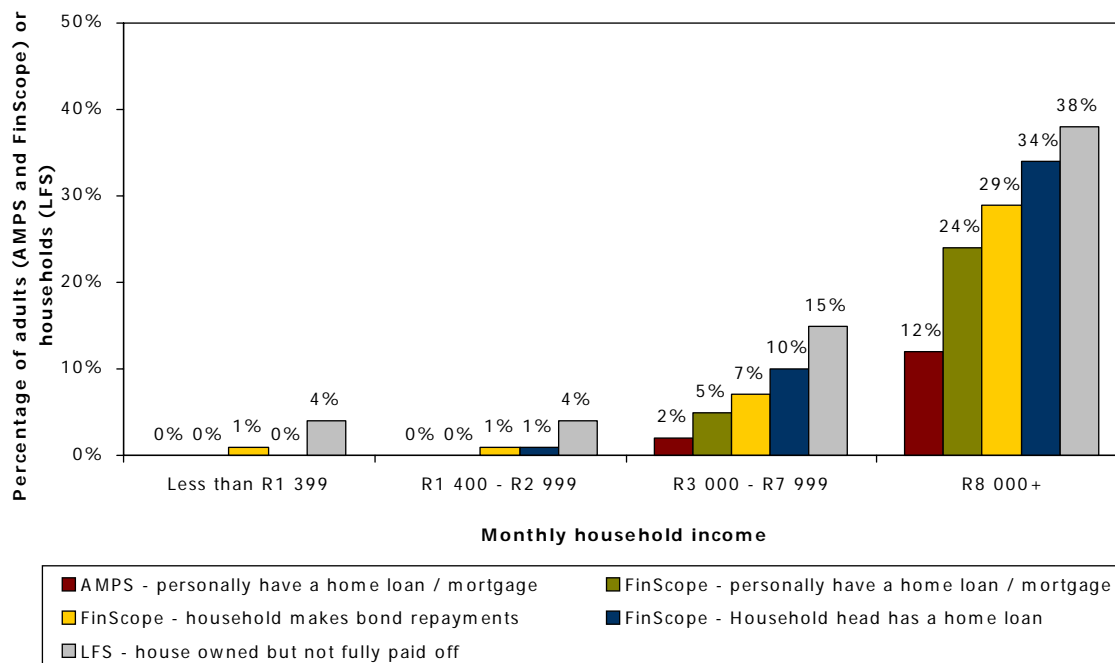
Source: LFS 2004

Various surveys, including AMPS and FinScope™, probe usage of mortgage products more specifically. Typically, individual survey respondents are asked whether they personally have a mortgage bond. According to AMPS 2005, around 170 000 individuals in the target market have a home loan or mortgage while FinScope™ (core survey) finds that 265 000 individuals personally have a home loan or mortgage bond. The reason for the discrepancy between AMPS and FinScope is not clear.

It should be noted that the unit of analysis in both AMPS and FinScope™ is the individual rather than the household. This presents a challenge when assessing penetration in the target market, as it is the number and proportion of households that have a mortgage that is of interest rather than the number of people who personally have a mortgage (two or more people may have the same mortgage; alternatively, a number of people who do not personally have a mortgage may live in a household that has a mortgage). There are two ways to overcome this. The first is to calculate how many members of households benefit from access to a mortgage. According to FinScope™, roughly 3.8% of adults aged 16 or more in the target market live in a household that makes bond repayments. Assuming that adults are distributed uniformly across households this should provide a proxy for the percentage of households in the target market that have a mortgage. However, 4.5% of respondents in the target market don't know if their household makes bond repayments. This clearly undermines the reliability of the estimate. A second option is to restrict the analysis to those respondents who are the head of the household, on the assumption that there is one household head per

household<sup>35</sup>. According to FinScope™ 230 000 household heads in the target market (or 4.8%) have a mortgage<sup>36</sup>.

Chart 16. Usage of home loans: Percentage of adults or households<sup>37</sup>



Source: FinScope™ 2005, AMPS 2005, LFS 2004

For the purposes of this study, it appears reasonable to assume that, in line with FinScope™, around 5% of households in the target market have mortgage loans.

It should be noted that despite the limitations of the survey data noted above, with the exception of AMPS, the data clearly illustrates that usage (personal or household) of mortgage products among those who have a monthly household income of R8 000 or more differs significantly from usage among lower-income households. This suggests that the FSC target of households earning between R1 500 and R7 500 is in principle appropriate, given the intention to broaden access to housing finance.

<sup>35</sup> This assumption appears to be incorrect; according to FinScope™ 2005 there are 5.4 million household heads in the target market. This exceeds all estimates of the size of the target market. However, if the degree to which the number of household heads is overstated is uniform across segments that do and do not have a mortgage, the results of the analysis will remain unchanged.

<sup>36</sup> This data is from the core survey. There is a discrepancy between the core survey and data in FinScope™ DMH survey which contains more detailed questions relating to housing. According to that survey 187 000 household heads in the target market or 3.4% have a mortgage.

<sup>37</sup> Note that the income categories for the different surveys are not aligned. The category labels shown above correspond to AMPS. The lowest income category for FinScope™ and the LFS is R1 499. The highest income category for the LFS is R7 500.

### *The market redistribution zone*

Typically, a cut-off installment of between 25% and 30% of household income is used to identify the affordability constraint for mortgage products. Given that the lower bound of the FSC target market is R1 500, any mortgage with an installment of no more than R450 per month would theoretically be affordable to even the lowest income household in the target market. Assuming a 20-year term and an interest rate of 12.5%, such a household could afford a bond of around R40 000<sup>38</sup>.

According to FinScope™ however, the most frequently cited reason for not having a bond in the target market relates to affordability – 46% of those aged 25 or more without a bond in the target market say they can't afford it. It is worth making the obvious point that perhaps it is not the bond that is unaffordable, but the property. Furthermore, stated ability to afford may not be a true reflection of the capacity of the household to make bond repayments if it chose to do so. While the percentage of those citing affordability as the key constraint declines as household income rises, there is still a sizeable minority of those who are relatively well off, who say they can't afford a bond - almost a quarter of those without a bond who have a household income of more than R8 000 per month cite affordability as a reason they have no bond. Such households may choose to prioritise other non-housing, non-essential expenditure. Affordability may also reflect differentials in the cost of owning compared to the cost of renting, particularly in areas that have seen rapid growth in house prices recently and where rental yields are low. Clearly, any analysis of affordability, in the context of the access frontier, must distinguish between households that are too poor to afford basic housing financed by a bond and those that are not.

While the target market does not comprise the 'hard-core' poor, poverty and deprivation are nonetheless realities for many individuals and households. There is no objective rule to define whether a household is too poor for a mortgage - other research has demonstrated that the poor have the capacity to save and service debt. Nevertheless, where a household is unable to meet its most basic needs, obtaining formally financed shelter is not likely to be a priority.

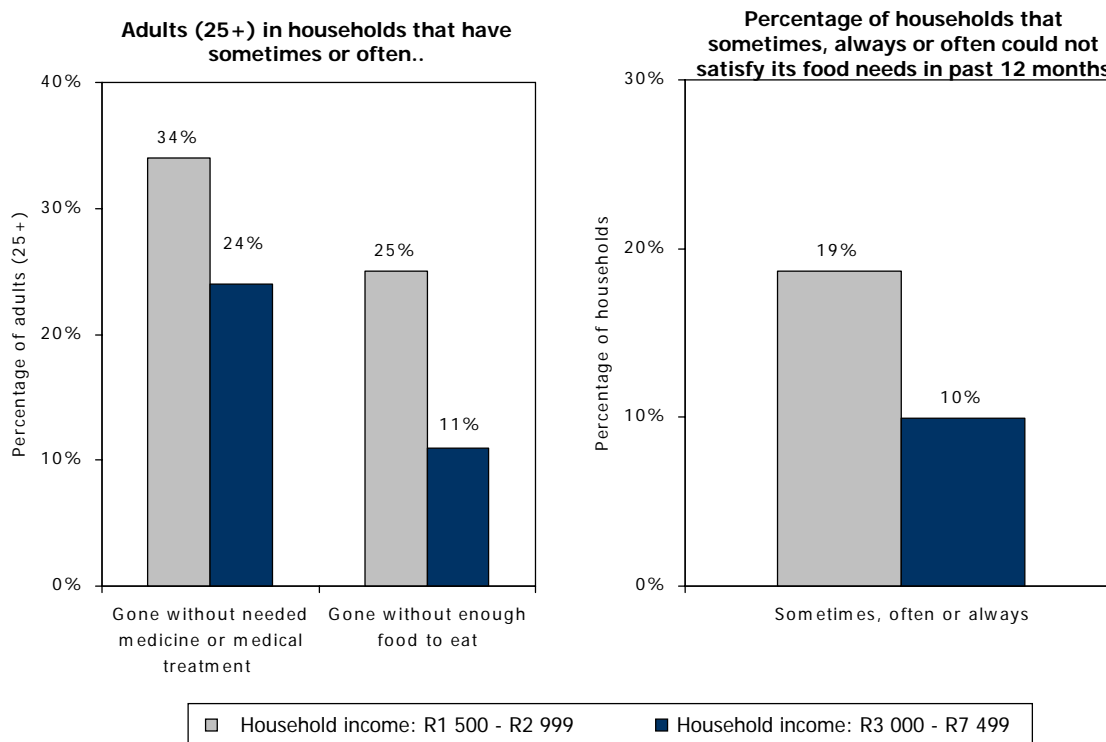
According to FinScope™, many of those aged 25 or more in the target market cannot provide for their basic needs including food (20%) or medical treatment (29%). Such households are likely to be too poor for a mortgage. Surveys such as the LFS or GHS can help to determine the number of households, as opposed to individuals in the target market who are likely to be

---

<sup>38</sup> This household may also be eligible for a housing subsidy of R32 000, enabling the household to purchase a house for R72 000.

too poor for a mortgage. Data from the LFS indicates that 14% of households in the target market are unable to meet their food needs<sup>39</sup>.

Chart 17. Poverty in the target market by monthly household income



Source: FinScope™ 2005, LFS 2004

Note: The upper income categories in FinScope™ 2005 is R3 000 – R7 999

Given that the size of the household has a direct bearing on poverty a per capita income measure may also be useful when trying to identify those who are likely to be too poor to afford housing finance. As noted earlier in this document 10% of households in the target market have a per capita income of less than R10 per day<sup>40</sup> while a further 25% have a per capita income of between R10 and R20 per day.

Based on various indicators of poverty, as described above, it would appear that between 15% and 20% of households in the target market are likely to be poor for mortgage finance even though a straight income assessment would suggest affordability. These households are not likely to be able to access housing finance without non-market interventions<sup>41</sup>.

<sup>39</sup> 19% of households with a monthly household income of R1 500 to R2 999 had problems satisfying their food needs sometimes, often or always in the 12 months preceding the survey, while 10% of households with a monthly household income of R3 000 to R7 499 had problems satisfying their food needs sometimes, always or often.

<sup>40</sup> Based on AMPS data Per capita income is calculated by dividing the midpoint of the AMPS household income band by the number of adult equivalents in the households. Children under the age of 10 count as half an adult. The per capita income cut off of R20 per day is based on an international norm of \$4 per day as a cut-off point to identify the poor.

<sup>41</sup> According to FinScope™, around 70% of household heads whose households do not have enough food to eat have a monthly household income of less than R3 000. According to AMPS, almost 90% of those who have a per capita of

### ***The market development zone***

#### *Borrower fails to meet lender criteria*

Aside from those who are too poor, households that fail to meet lender criteria do not have access to mortgage finance. These criteria were discussed in detail in the review of supply of mortgage products. This section of the document uses survey data to quantify the implication of these criteria on access levels in the target market.

#### ■ Income level

Given that mortgage products that are theoretically available for all households in the target market<sup>42</sup>, no additional income level constraint is incorporated in the analysis of access levels.

#### ■ Income source and stability of income

As noted, banks include all stable income sources, including salaries, wages or profits earned in the informal sector, in their affordability calculations. Typically, the stability of these income sources is assessed in the light of historic data (verified by an analysis of bank statements for instance) or via a demonstrated ability to save regularly (ABSA requires those who are informally employed to build up a savings track record for nine months<sup>43</sup>).

Households in the target market that do not have a stable income profile do not have access to mortgage finance. According to FinScope<sup>TM</sup>, over 40% of household heads in the target market live in households where income appears to be sporadic ('family goes without cash income often or sometimes'). Assuming, once again, that the household head is fair representation of the household, 40% of households in the target market are unlikely to be successful candidates for a mortgage. Excluding those who are unlikely to be able to access a mortgage because they are too poor (proxied by those who cannot meet their nutritional needs), approximately one third of those who do not have a mortgage may not qualify for a mortgage because their households sometimes or often go without cash income.

#### ■ Affordability

As part of the loan application process, borrowers provide a breakdown of monthly household expenditure to enable lenders to assess affordability more rigorously and to

---

less than R30 per day have a monthly household income of less than R3 000. These households would qualify for a housing subsidy (neither FinScope<sup>TM</sup> nor AMPS provides an income band at R3 500).

<sup>42</sup> In reality, banks have indicated that mortgage loans are unlikely to be appropriate for households earning less than R2 500 or R3 000 per month. According to the LFS, one third of households in the target market who are not too poor<sup>42</sup> for a mortgage earn less than R2 500 per month. This is in line with the proportion of household heads in FinScope<sup>TM</sup> similarly defined.

<sup>43</sup> ABSA offers 4% interest on these accounts.

assess the extent to which households in the target market have the capacity to service further debt.

The NHFC survey found that 34% of unsuccessful homebuyers could not access finance because of existing debt. While no accurate, current survey data exists on indebtedness levels within the target market<sup>44</sup>, FinScope™ can provide some indication as to the capacity to absorb further credit within the target market. According to that survey almost 40% of household heads in the target market, who do not have a bond and are not in the market redistribution zone, claim not to have any funds available after paying bills (80% of these individuals currently do not make any payments for rent or housing).

Of course, credit usage is unlikely to be static and, given the fungible nature of money, may well reflect the nature of available credit products rather than the underlying needs of the household. Thus, as households (particularly those who wish to purchase a house) incorporate the availability of housing finance products into their credit consumption function, there may well be an adjustment in household non-housing debt usage and associated indebtedness levels<sup>45</sup>.

Various surveys confirm that current expenditure on housing in the target market is very low, indicating that newly incurred expenses relating to home ownership cannot be funded by other housing expenditure that is no longer necessary. The 2003 NHFC survey found that 77% of households in the target market do not make regular housing payments. Likewise, in 2004 the GHS found that 52% of those with a monthly household income of R1 500 to R3 499 and 35% of those with a monthly household income of R3 500 to R7 499 do not have any housing expenditure. Thus, a significant realignment of household expenditure in favour of housing is likely to be required for first-time mortgagees.

While the availability of funds that can be diverted to housing may be limited in some households, the 2003 NHFC survey shows that two thirds of prospective buyers allocate a

---

<sup>44</sup> While credit usage could be used as a proxy, this is problematic for two reasons. In the first instance FinScope™ and other surveys appear to understate credit usage significantly. According to FinScope™ less than 1% of all adults (192 000 people) in South Africa have loans from a micro-lender such as African Bank or Capitec. The survey finds that 30% of adults aged 25 or more in the target market have credit facilities at retailers. In contrast, the NHFC survey found that 79% of prospective homebuyers in the target market have accounts at clothing retailers while 58% have accounts at furniture retailers. Secondly, even if credit usage data were available, its use is not necessarily a problem for housing lenders. If non-housing debt is well managed, there can be a number of positive spin-offs for housing lenders. Households that have been exposed to debt have established repayment track records that can be used by lenders for profiling purposes. In addition, households that have had experience with credit are likely to be familiar with the obligations associated with borrowing.

<sup>45</sup> In the short term, high levels of indebtedness provide an opportunity for those who facilitate access to mortgage finance, such as mortgage originators and estate agents, to extend their range of services to include debt consolidation and counseling services.

significant proportion of their incomes to saving for a house. In addition, the same survey found that around 10% of household expenditure is spent on discretionary items such as entertainment, gambling or alcohol, which presumably could be redirected towards housing if access to a mortgage was secured.

■ Credit history

Lenders investigate the credit history of potential borrowers using credit bureau data. According to FinScope, 9% of household heads in the target market who do not have a bond say they are listed with credit bureaus, while 1.9% say they are under debt administration (0.5% of those who are not too poor and do not have a bond). Both these statistics are likely to be significantly understated. In total across all markets, FinScope™ finds that just below 1.5 million people are listed with credit bureaus while according to the Credit Bureau Association, of the 18 million individuals who have applied for credit at some stage 3.5 million have some kind of adverse listing while 2.4 million are blacklisted<sup>46</sup>. It is worth noting that 14% of those aged 25 or more in the target market do not know if they are listed<sup>47</sup>.

■ Age

To qualify for a mortgage, borrowers must be 21 or older. In addition, lenders typically require the loan to be repaid in full before the borrower retires. Long-term mortgages for borrowers aged 45 or older are therefore not feasible. In the target market, over half of all households heads who are not too poor for a mortgage, and who are unlikely to be disqualified based on the affordability criteria discussed above, are headed by an individual who is older than 45<sup>48</sup>.

*Property or area fails to meet criteria*

If the borrower meets lender criteria, an assessment of the property will be undertaken<sup>49</sup>. Minimum property standards are not static nor are they easily documented. Lenders and mortgage originators have noted that the assessment process is, by its nature, subjective and that assessments will differ on a case-by-case basis. Policies therefore appear to be somewhat flexible, although broadly based on NHBRC building standards. A few of the more typical property criteria are summarised below.

---

<sup>46</sup> Source: "Credit Bill Aims to Pull Loan Shark's Teeth", Sunday Argus, August 14 2005, by Lauren Cohen

<sup>47</sup> As noted earlier in this report, lenders have begun to place more weight on indications of rehabilitation (for example, the client has managed to make repayments consistently in the recent past) than on more dated judgment or arrears information. Several banks have highlighted this as a significant change from past practices. In the absence of any data on rejection rates it is not possible to assess the impact of this change on access.

<sup>48</sup> Note that the head of the household may not be the highest wage earner in the household

<sup>49</sup> Property and area characteristics impact on the realizable value of the collateralized asset, as well as on the borrower's willingness to repay. Given limited recourse to other service providers, including building contractors and municipalities, the remedy of last resort for a dissatisfied household is often to cease making bond repayments. In addition, in areas where municipal service delivery and collection capabilities are poor, there is often a spillover effect on mortgage repayments.

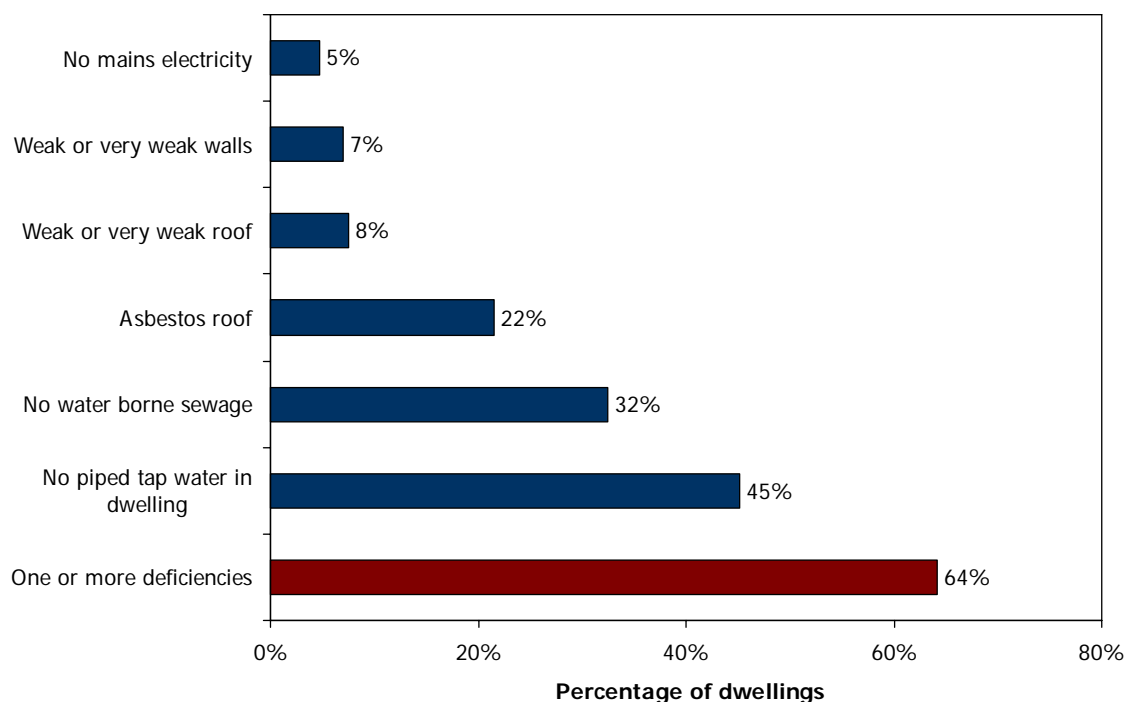
Table 6: Typical property requirements

New developments	Existing properties
<ul style="list-style-type: none"> <li>■ Sites located in areas zoned for residential purposes</li> <li>■ Water connection, water borne sewage and electricity at each site</li> <li>■ Units at least 35 square metres on stands of at least 200 square metres</li> <li>■ Building materials conform to NHBRC standards</li> <li>■ Sink or basin inside the house</li> <li>■ Bathroom (incorporating toilet and bath / shower)inside the house</li> </ul>	<ul style="list-style-type: none"> <li>■ Sites located in areas zoned for residential purposes</li> <li>■ Water connection, water borne sewage and electricity at each site</li> <li>■ No minimum house size specified. Stand to be at least 200 metres</li> <li>■ Sink or basin inside the house</li> <li>■ Bathroom (incorporating toilet and bath / shower)</li> </ul>

Source: Proposed property types and minimum specifications, Project Sizwe<sup>50</sup>

A review of the characteristics of formal properties owned by the target market indicates that over 60% do not currently meet with these standard requirements.

Chart 18. Characteristics of owned formal houses in the target market



Source: GHS 2004

Aside from physical characteristics that might disqualify houses, properties that have no title deeds are also unmortgageable. According to FinScope™ 2004, approximately 35% of the

<sup>50</sup> It should be noted that these requirements were developed for assets to be included in a proposed securitised pool. However, based on discussions with banks it appears that these requirements are fairly standard.

four million adults in the target market who own formal houses say they do not have formal proof of ownership of their homes (these respondents say they do not have proof of ownership of both the land and building).

*Other barriers to access*

Physical access, awareness levels and attitudes to lenders are other factors that could limit access to mortgage products. According to FinScope™, 4% of household heads who appear to qualify for a home loan, based on the analysis of FinScope™ data, say they cannot access the product. FinScope™ also finds that 22% of those who would otherwise qualify for a mortgage in the target market are unbanked. This clearly impacts on the ability to provide a financial track record for assessment purposes. According to data from the 2003 NHFC survey, one third of potential homebuyers indicated that complexity with regard to the process of obtaining housing finance, as well as the range of products, negatively impacted on their ability to purchase a house.

Other barriers to access arise from poorly implemented product roll-out strategies within the lender's branch network, and low product awareness levels among customer-facing staff. Once again, it is not possible to quantify the impact of these barriers.

*Summary: Market development zone*

Using data on ***borrower characteristics only*** (i.e. ignoring those who do not have access because the property they wish to mortgage does not comply with lender requirements), it appears that over 50% of households in the target market lie in the market development zone. Adding those who are too poor for a mortgage, 75% of households in the target market do not have access to mortgage products marketed by the banks.

***The market enablement zone***

This zone comprises approximately 20% of the target market and comprises potential borrowers who do not have a mortgage but who have access to the product and could potentially obtain one should they wish to do so. It should be noted, that once again, the estimate of the size of the market enablement zone is based on borrower characteristics only.

Clearly, some households within this zone may choose not have a mortgage product. According to FinScope™, almost 40% of the households in the market enablement zone responded 'don't want it' when asked why they don't have a mortgage<sup>51</sup>, corresponding to

---

<sup>51</sup> While FinScope™ asks respondents why they don't have a mortgage, the data is not easy to interpret. Reasons include 'can't afford it', 'don't want it', 'don't own a home and so don't qualify', and 'my house is fully paid for'

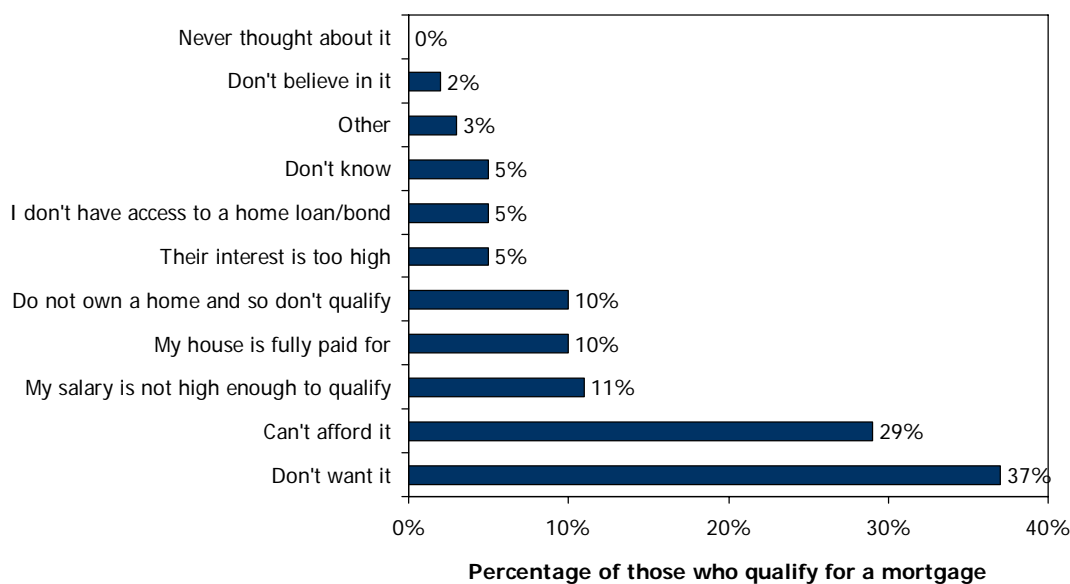
around 320 000 households<sup>52</sup>. These households lie beyond the natural limit of the market, although, as Porteous notes, this segment should be monitored to identify any shifts in preferences over time.

Excluding those who do not want a mortgage, it appears that 12% of the target market have access to existing bank-provided mortgage products, corresponding to around 480 000 households.

According to FinScope<sup>TM</sup>, affordability is still a significant factor in the market enablement zone, although as noted earlier in this document, it is not necessarily the bond that is unaffordable, but the underlying housing asset. It should be noted that FinScope<sup>TM</sup> does not offer respondents an option relating to lack of availability of housing units.

Of interest too, is that around 10% of those who actually qualify for a mortgage believe that they earn too little to obtain a mortgage. Clearly, further marketing is required to reach these households.

Chart 19. Reasons for not having a mortgage or home loan of those who would qualify for the product



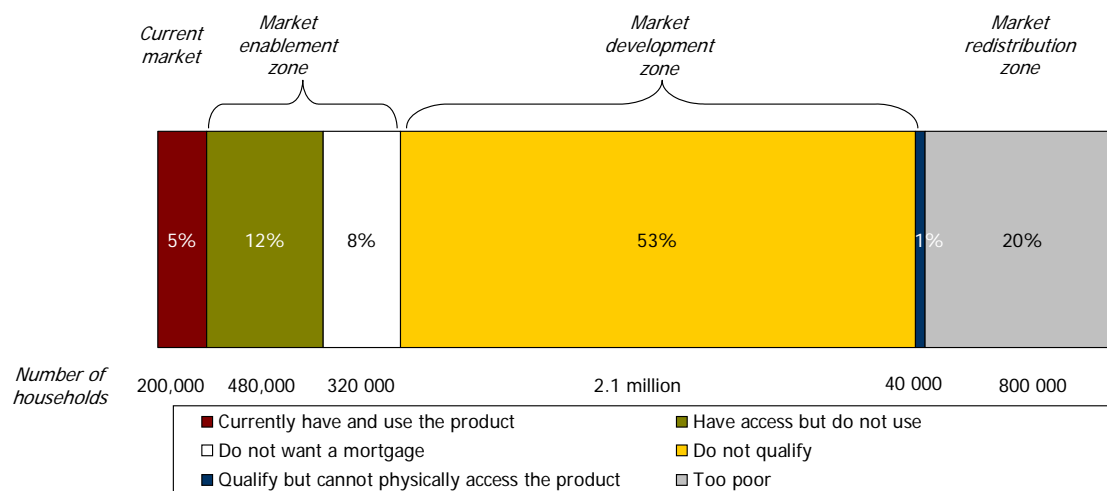
Source: FinScope<sup>TM</sup> 2005

<sup>52</sup> This assumes there are four million households in the target market.

### The access frontier for mortgage finance

The findings of the access investigation are summarised in the diagram below.

Chart 20. Access frontier for mortgage finance in the target market



Source: Underlying data based on FinScope™ 2005 using household heads

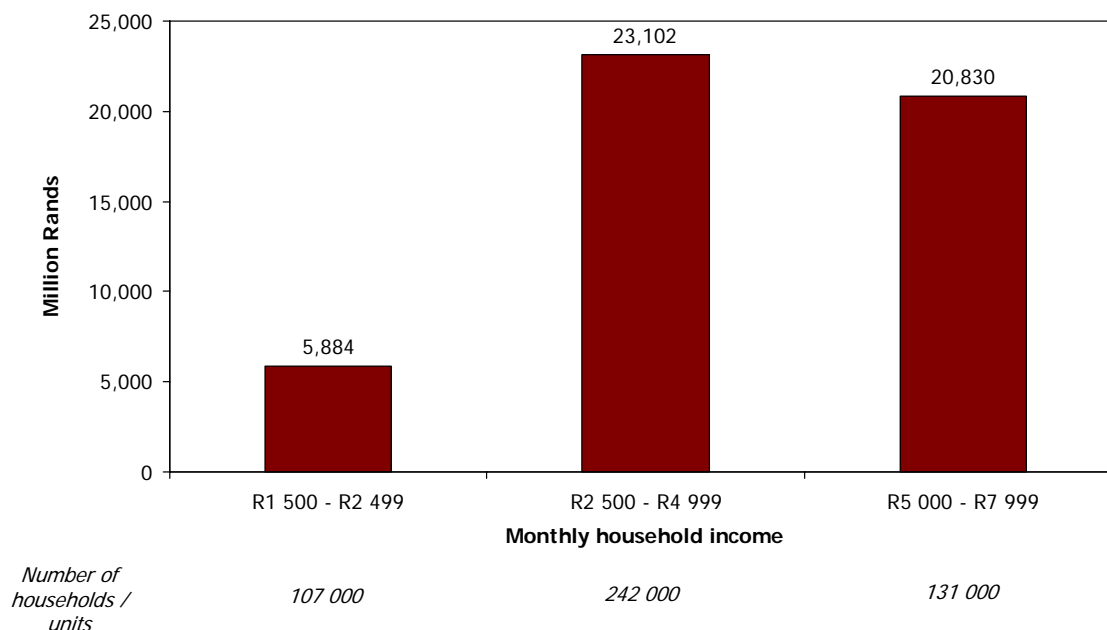
Note: percentages do not add up to 100% because of rounding

The requirement that loans be repaid in full before retirement has a significant impact on access. If this constraint is relaxed, the proportion of the target market that would qualify for a bond increases from 20% to over 40%.

As expected, lower income households are less likely to qualify for a mortgage than higher income households in the target market. Based on an analysis of FinScope™ data, less than 10% of those with a household income of less than R3 000 per month would qualify compared to around 20% of those who earn R3 000 or more.

Excluding those who do not want the product, the potential value of the market enablement zone, assuming a 20-year bond at 12.5% with a 30% installment-to-income ratio, is approximately R52 billion. Whether all these households would in fact want to take out a bond within the current FSC window is open to debate. For instance, many of those who live on their own may not be candidates for a mortgage. According to FinScope™, excluding those who do not want the product, 23% of those in the market enablement zone live on their own.

Chart 21. Value of the market enablement zone – excluding those who do not want a mortgage



These findings should be interpreted with care. As noted, surveys typically under-report true incidence of characteristics that are deemed to be sensitive by the respondent<sup>53</sup>. In addition, other factors that cannot be quantified using available data will disqualify or discourage potential borrowers<sup>54</sup>. There is also no indication of the extent to which access criteria for which there is some data intersect with those for which there is none (for example, of those who are over-indebted, what proportion are too old for a mortgage?). All in all, the estimate of the size of the market that has access, at 12%, may well overstate true levels of access.

**Other external barriers to access - Cannot find an affordable house**

While 12% of the market theoretically has access to mortgage finance, many of these households may be unable to find an affordable home. The 2003 NHFC End User Survey found that the shortage of housing stock is the most significant factor preventing potential homebuyers from purchasing a house. According to that survey, 50% of unsuccessful homebuyers indicated that they had been unable to find an affordable house.

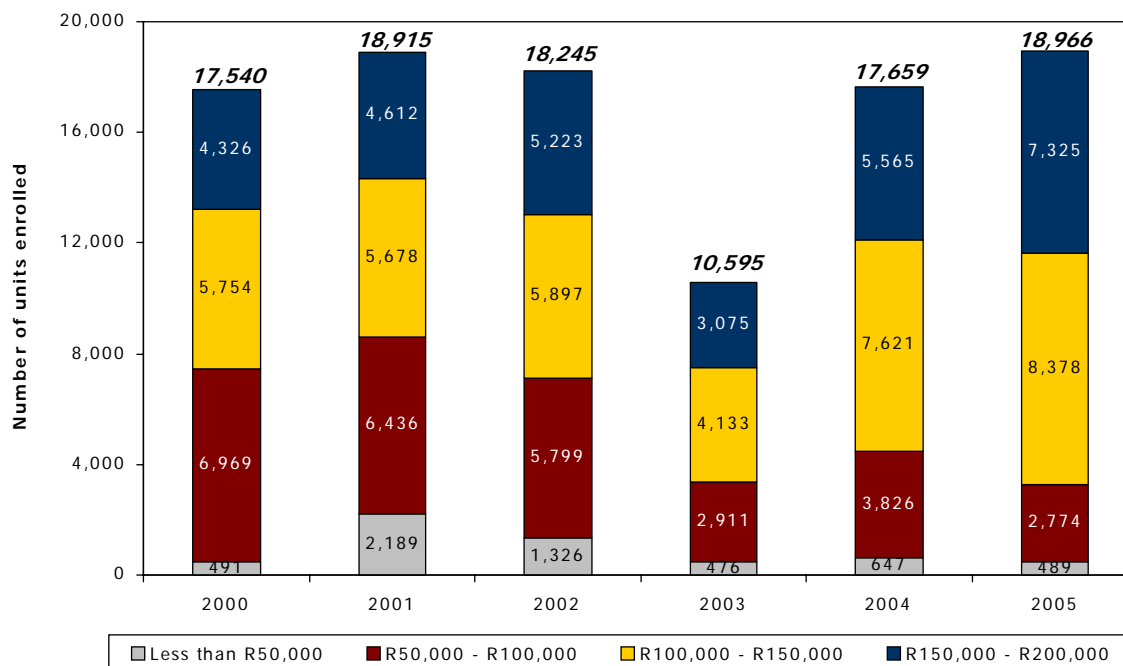
The Banking Association of South Africa (“BASA”) study on housing supply also highlights the shortage of housing stock in the target market. This shortage, partly a result of the persistent lack of housing finance and investment in the target market in the past, is likely to be a significant, if not the most significant, underlying cause of what is termed the “dysfunctional”

<sup>53</sup> This is certainly the case with credit bureau listings.

<sup>54</sup> This includes levels of indebtedness.

nature of low income housing markets in South Africa<sup>55</sup>. According to the BASA study, an average of 18 000 affordable housing units are constructed each year. If building activity continues at this rate it would take over 45 years to provide housing for those who are inadequately housed in the target market<sup>56</sup>.

Chart 22. Number of low cost units enrolled per annum (2000 – 2005)



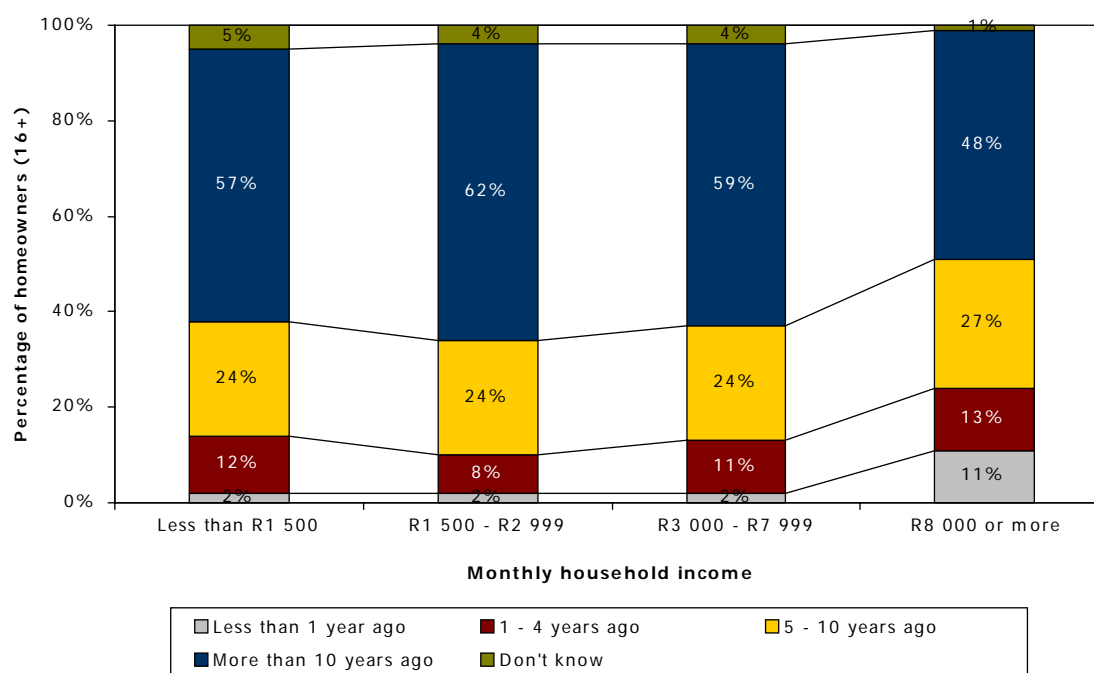
Source: NHBRC data as reported in Research into Housing Supply and Functioning Markets

There are also relatively few secondary market transactions in the target market. The 2004 Township Residential Property Market (“TRPM”) study found that formal churn of privately developed township properties averaged 12% over five years compared to 30% for non-township properties. This is confirmed by FinScope™ data. According to that survey, homeowners in the low income market are far less likely to have moved into their homes during the past five years – while a quarter of higher income households have moved in the past five years, only 11% of those in the target market have done so.

<sup>55</sup> Crime, politically motivated or housing quality related non-payment are other factors. Based on discussions with various participants in the low income housing finance sector, it appears that these are less significant factors at this stage than they have been historically.

<sup>56</sup> Based on an estimate of the housing shortfall in the target market of approximately 850 000 units

Chart 23. When did you move into this home?



Source: FinScope™ 2005

The Banking Association study investigated the number of secondary market transactions in the affordable property segment registered with the deeds office. According to that data, there were just under 72 000 secondary market transactions in 2004. Once again, this data includes transactions by households that may lie outside the target market parameters.

While there is clearly a lack of housing stock, the extent to which this shortage has impacted negatively on access to mortgage finance is unclear. The vast majority of potential homebuyers who cannot find a house may not qualify for mortgage finance in the first instance. If this were the case, it would be misleading to ascribe the lack of access to mortgage finance to housing stock shortages alone.

If the estimate of the number of households who have access to a mortgage, at 480 000, is accurate as is the estimate of 70 000 affordable mortgages granted a year as per deeds office data reported in the housing supply study, this would not seem to indicate a significant mismatch between access to mortgages and the availability of housing stock. Thus, stock shortages, while certainly present, may not be materially impeding access to mortgages. Rather there is an access constraint with regard to mortgages independent of the shortage of stock. If housing stock were to increase dramatically, there may not be a corresponding increase in the number of households who are able to secure mortgage finance, if the product remains in its present form (that is, a 20-year product).

It would appear from this analysis that strategies must be developed to increase both access to mortgages and other housing finance products in tandem with improving the availability of other critical inputs in the housing supply chain. Where physical stock is in short supply, a dramatic increase in the availability of housing finance in the absence of a concomitant increase in other underlying housing inputs may lead to an increase in the price of houses creating a binding affordability constraint for low income households<sup>57</sup>. Likewise, if vast numbers of houses are built but not enough households can obtain finance to purchase them the housing market will collapse.

---

<sup>57</sup> For a brief discussion on this see Financing Urban Shelter - Global Report on Human Settlements 2005 pp 80. "If supply does not increase or only increases slowly there is no reason to believe that a more efficient housing finance market will result in better housing (even in the short or medium term); it will simply result in rising house prices. The increase in the availability of housing finance assumes that more dwellings will be produced and or marketed in response to increased demand and, hence, that homeownership will rise. But how responsive is supply to demand?"

## ACCESS TO HOUSING FINANCE IN THE LOW INCOME MARKET – THE CHALLENGE FOR BANKS

There can be no doubt that the FSC has had a significant impact on banks, and in particular on the structure and functioning of their low income mortgage divisions<sup>58</sup>. Most banks have begun actively marketing specific mortgage products for the low income market. In addition, some have restructured their home loan divisions to ensure that the low income market receives attention commensurate with its perceived importance rather than its relatively small share of the total home loan portfolio.

As noted elsewhere in this report, banks are not willing to make data available on the size of their low income loan books or their annual advances to this segment. Some banks claim that this information is too sensitive to reveal, while others prefer to wait until such statistics have been audited.

The lack of reliable trend data with respect to the usage of mortgage products in the target market frustrates efforts to assess the extent to which usage has increased and how far down the household income scale such lending extends. The reluctance on the part of the banks to share such data, even if qualified, is puzzling and, in light of recent comments in the press by senior politicians with regard to the slow pace of housing finance delivery, only serves to confirm suspicions that such lending remains limited. Given that banks are unwilling to provide this data voluntarily, there is a clear need for disclosure legislation to be implemented as soon as possible.

Most banks are fairly confident that, between end-user finance and project finance, the FSC targets will be met. However all banks cited the shortage of housing stock as the single most significant obstacle that could prevent them from meeting the FSC target<sup>59</sup>. Banks ascribe the slow pace of low-cost private sector housing development to a shortage of land and a lack of capacity at local government level, resulting in costly delays. They believe this has led to a decline in developer interest in the sector.

While the impact of costly delays in planning and bulk service delivery is no doubt significant, it is also true that the limited availability of housing finance for developers and end-users in

---

<sup>58</sup> Some comments from interviews with banks and representative of the banking industry:

- "The FSC changed things dramatically for the banks"
- "The FSC targets are spoken about all the time". A comment from the same interviewee regarding a conversation in passing with the CEO who said to him "You must and will meet the target".
- Comment from a developer who went to the press about not being able to get finance from one of the banks "I ended up in (the CEO's) office. Then he sent (the divisional head) to talk to me. I got the finance within 14 days"

<sup>59</sup> Comment from interview with a bank: "There can be no lending at scale until supply is increased significantly"

the past has also contributed significantly to the low levels of activity in low-cost housing that currently characterize the market. The removal of this bottleneck is therefore a significant step. Developers can now be relatively certain that they will find project finance and that the target market will be able to secure funding to purchase completed units. That lead times are long (even if optimized) is an unfortunate reality of the housing supply chain but it is one that should not prevent banks from committing earmarked capital to the sector.

Aside from the slow pace of housing delivery, a number of other challenges remain. These include the optimization and modification of existing mortgage products and their associated processes to align with the needs and risk profile of the target market. At a higher level, banks also need to engage productively with government to demonstrate clearly if and where additional non-commercial interventions are required in order to enhance access to housing finance in the target market.

Even if optimized mortgage products are unlikely to meet the needs of the majority of households in the target market. Thus, the development or support of non-mortgage housing finance products, specifically incremental housing loans, is also required if access to housing finance is to be enhanced in the target market.

#### *Risk management and access*

Mortgage lenders operationalise their risk management strategies<sup>60</sup> through a combination of four broad lender-controlled levers or interventions: the qualifying criteria relating to the borrower and the property (including the area); the features of the product (including pricing, insurance riders, deposit requirements and so on); the lender's loan servicing capabilities and various portfolio interventions (including diversification, and portfolio insurance or guarantees). These areas must be aligned to deliver the appropriate risk / return trade-off required by the lender.

The way in which these areas are optimized clearly has an impact on access. For example, the potentially negative financial consequences of weak loan servicing capabilities may be offset by more stringent assessment criteria that result in curtailed levels of access for segments of the market<sup>61</sup>. Alternatively, product features such as fixed interest rates or

---

<sup>60</sup> There are four broad risk management strategies: avoid risk, transfer risk, retain risk and reduce the impact of risk.

<sup>61</sup> A 2003 NHFC study into the causes of default found that in almost one quarter of cases of default, there was no immediate lender reaction after the borrower had fallen into arrears (Source: : "Reasons for non payment of mortgage loans and municipal services", NHFC, March 2003). Fannie Mae undertook a review of loan servicing practices of South African lenders in early 2004. The research team made a number of observations regarding critical weakness in servicing capabilities of low income housing lenders:

- Some institutions have limited physical presence within targeted communities
- Few decision-makers dealing with the low income market are themselves from the target market
- Some lenders have not developed appropriate contact methods for the low income market

mandatory insurances may increase the total costs of credit to the borrower, once again impacting on access. Innovation and experimentation with respect to assessment criteria, product features and loan servicing processes is therefore critical if access to mortgage finance is to be enhanced in a sustainable way.

It would appear that industry efforts regarding the FSC commitments have focused primarily two key areas: obtaining a state guarantee to limit losses associated with mortgage lending in the low income market arising from non-commercial risk<sup>62</sup> and obtaining a fixed interest rate hedge to reduce the interest rate differential between a prime-linked mortgage and a fixed rate product in order to make the latter more affordable<sup>63</sup>. Data presented by the Banking Association indicates that these mechanisms could enable banks to lend an additional R12 billion to the target market<sup>64</sup>.

**However, the question remains: To what extent and through what mechanisms will these initiatives expand the access frontier so that more of the target market benefits from having real access to housing finance?**

Potentially, the loss limit insurance could also allow lenders to alter assessment criteria and 'expand the underwriting envelope'<sup>65</sup> enabling them to accept applications that might previously have been rejected or to lend in areas where risks are currently believed to be too high. However, this appears not to have been the primary underlying motivation for the current proposals<sup>66</sup>. Rather, the primary motivation for this mechanism appears to be to facilitate the participation of non-banking signatories of the FSC in the provision of capital for low income housing finance principally via investment in securitised low income housing loans. Such insurance would enhance the credit risk of the asset pool significantly and reduce the cost of funding.

In order to assess the degree to which access to mortgage finance could potentially be enhanced through a portfolio guarantee, further analysis of bank data is required as is

- 
- Many lenders rely too heavily on payroll deduction facilities and have therefore not developed adequate collections processes for borrowers who do not have such facilities
  - Lenders have limited information on the costs of servicing low income loans compared to other home loans.  
(Source: "Low Income Housing Loan Servicing: South Africa" prepared for The FinMark Trust, June 2004)

<sup>62</sup> These risks cannot be accurately assessed or priced and arise from factors such as political instability, poor municipal service delivery or weak municipal collections capabilities. The Banking Association has proposed that this insurance be funded by a levy on bondholders.

<sup>63</sup> As noted earlier in this document, such a product would only partially deal with default risk arising from interest rate increases. Often a more significant cause of default associated with interest rate increases arises from a general contraction of the broader economy leading to retrenchments. While voluntary retrenchment insurance is available, it is expensive and take-up rates are reportedly low. There may well be a case for the provision of subsidised retrenchment cover that would protect borrowers as well as lenders or investors.

<sup>64</sup> Source: Presentation of the Banking Association, 15 March 2006

<sup>65</sup> Source: "The Growing World of Mortgage Default Insurance" by Roger Blood.

<sup>66</sup> In fact, it could be argued that specifications regarding the property criteria for loans included in the securitised asset pool may further entrench rigid assessment practises rather than encourage experimentation and innovation.

greater disclosure on current exclusion policies with regard to certain areas. At the most basic level, access is determined at the point of sale where lenders assess each loan application. Thus, an analysis of data on the primary reasons borrowers are rejected could provide much insight into what, if any, interventions are required to increase access among those who have seemingly overcome other barriers to access (such as the inability to find a suitable house). In addition, an analysis of default patterns in the early stages of the life of the loan can help to identify what additional criteria (if any) could be relaxed and how associated additional risks could be managed. Finally, disclosure on the number and size of areas currently excluded by lenders could enable an assessment of the potential impact of guarantees on the development of a stable housing market. The availability of such data would thus enable lenders to link any proposed portfolio guarantees directly to the question of access by quantifying the number of currently rejected applications that could be accepted if the proposed guarantees were in place and by estimating the number of households that are currently unable to access mortgage finance because of their location<sup>67</sup>.

#### *The range of available housing finance products*

While mortgage lending to higher income sub-segments within the target market is likely to continue to account for the bulk of bank activity in the low income housing finance sector, it remains to be seen how far down the income scale mortgage lending can occur<sup>68</sup>. For those households that are unlikely to be able to afford or want a mortgage, smaller, unsecured loans may be more appropriate. Indeed, the analysis of demand conditions in the target market clearly demonstrates the need for such housing finance solutions across the entire target market.

Banks are active in the provision of various non-mortgage housing finance products including pension-backed loans and capital to support instalment sales. However, they appear to have only limited direct involvement in the provision of unsecured, smaller housing loans. While banks have recognised that there is a significant need for such loans<sup>69</sup>, innovation with respect to these products appears not to be an area of focus for the banking industry<sup>70</sup>.

---

<sup>67</sup> Of course, it should be noted that even if a strong case for default insurance exists it is not necessarily the case that such insurance should be provided by the State. There is evidence to suggest that such insurance can be provided sustainably by the private sector. For a detailed analysis of this issue, see 'Comparing Mortgage Credit Risk Policies – An Options-Based Approach' by Robert Buckley, Gulmira Karaguishiyeva, Robert Van Order and Laura Vecvagare, published by The World Bank, May 2003

<sup>68</sup> According to data provided by the Banking Association, R17 billion has been disbursed in the FSC target market over the past two years. Mortgage advances account for around R11bn, the bulk of which has been allocated to households with a monthly income of R4 000 or more. (Source: "Banks urge state to share the risk" by Nick Wilson, Business Day, 16 March 2006, discussion with representatives of the Banking Association of South Africa)

<sup>69</sup> Note various comments made by bank and banking industry representatives during interviews

- "If a household's income is R1 500 per month, can it really afford an installment?"
- "Often when people talk about housing finance they immediately think mortgages. However mortgages might not be appropriate for all in the target market"
- "Mortgages are not the only solution. We need solutions down the income scale."

<sup>70</sup> The partnership between Consumer Credit, a Nedcor subsidiary, and Cashbuild, South Africa's largest retailer of building materials is an example of bank participation in this sector.

Given the tight timeframes associated with meeting the FSC target, relatively long product development lead times and low Rand values associated with incremental housing loans, this is perhaps hardly surprising.

While it would require far more effort on the part of the banks to meet the FSC target through smaller loans, in many ways a focus on these products would enable banks to develop and support a more sustainable housing finance sector across the breadth of the target market going forward. The provision of such finance is not constrained by the shortage of mortgageable properties. In fact, if appropriately invested, smaller loans could enable households to improve the condition of their homes, improving their tradability and contributing to the supply of stock. As noted earlier in this report, 64% of formal, owned houses in the target market appear to be currently unmortgageable using criteria commonly applied by mortgage lenders. Incremental housing finance can also enable subsidy beneficiaries to improve the quality of over 1.8 million RDP houses constructed since 1994. These homes are often not regarded as mortgageable by mortgage lenders.

By interacting with the target market through smaller loans banks would also be able to learn about the product needs and risk profile of the target market without risking significant capital. In the process, they would develop relationships with potential mortgage clients who have used the proceeds of previous loans to enhance the value of their housing assets and may be in a position to trade up.

The recent performance of some micro-lenders (not necessarily housing lenders) indicates that the industry offers profitable opportunities for those who can develop the capabilities required to manage risk in this market<sup>71</sup>. In many cases, these capabilities overlap with those required for profitable mortgage lending. Thus the re-entry of banks into the micro-lending industry may be a natural extension of their present activities.

It is of course important to assess the extent to which significant bank participation in unsecured housing lending will enhance access to housing finance given that a range of solutions is already on offer and that bank participation may well impact on the viability of existing lenders<sup>72</sup>. In this regard, it may be more beneficial for the cause of access and the viability of small-scale housing lending for banks to engage with this sector by partnering with existing lenders who offer smaller housing loans. Such a partnership could enable housing

---

<sup>71</sup> The MFRC estimates that 10.7% of the value of disbursed micro loans are for housing purposes. In the quarter ending November 2005, R805 million was disbursed by the micro lending industry for housing.

<sup>72</sup> For a detailed discussion on the impact of bank participation in the housing finance sector on smaller lenders see Rust, K (2003) [Sink or Swim: Progress made in the relationship between banks and alternative lenders in South Africa's low income housing finance sector](#). Housing Finance Resource Programme Occasional Paper No 9

lenders to secure much needed capital and enable banks to enter the market without needing to invest heavily in developing required capabilities to operate efficiently in the market.

*Concluding comment*

As noted in the Financial Sector Charter, increasing access to financial services in general (and housing finance in particular) hinges on the development of “appropriate and affordably priced” products for the target market<sup>73</sup>. Thus, in the spirit of the FSC, any assessment of access to housing finance should incorporate the scope and potential reach of housing finance solutions available in addition to the value of loans disbursed. While the latter is easily tracked, indicators such as the participation of a range of players, the availability of a range of products, the extent of innovation both with respect to new products as well as the optimization of existing products are also instructive.

Ultimately, the challenge for the banking industry as it seeks to increase access to housing finance in the target market will be to meet the FSC housing target *and* to participate meaningfully across a range of areas of housing finance activity. Meeting this challenge will require continued effort on the part of the banks.

Based on the interactions with operational and senior managers interviewed as part of the study, it appears that these challenges are well understood. Further, there appears to be a genuine interest in the market and a real willingness to challenge historic practices and assumptions about the characteristics of credit-worthy clients and mortgageable properties within banks. This, together with the strong impetus from executive level within banks to the principles embodied within the FSC bodes well for the sector over all.

---

<sup>73</sup> Source: Financial Sector Charter, October 2003

## APPENDIX A

### *Data sources*

- FinScope™ Survey, 2005
- StatsSA Labour Force Survey, September 2004
- StatsSA General Household Survey, 2004
- SAARF All Media and Product Survey 2005
- NHFC End-User Survey, 2003

### *References*

- Archer, Ling and McGill (2001). Prepayment Risk and Low Income Mortgage Borrowers. Published by the Joint Center for Housing Studies, Harvard University
- Blood, R. The Growing World of Mortgage Default Insurance. Source unknown
- Buckley, Karaguishiyeva, Van Order and Vecvagare (2003). Comparing Mortgage Credit Risk Policies – An Options-Based Approach. Published by The World Bank
- Porteous, D (2005). The Access Frontier as an Approach and Tool in Making Markets Work for the Poor.
- Rust, K (2003). Sink or Swim: Progress made in the relationship between banks and alternative lenders in South Africa's low income housing finance sector. Housing Finance Resource Programme Occasional Paper No 9
- Keller, S (2004). Household Formation, Poverty and Unemployment – The Case of Rural Households in South Africa. Stellenbosch Economic Working Paper 1/2004, University of Stellenbosch
- Banking Association of South Africa (2006). Research into Housing Supply and Functioning Markets.
- Project Sizwe (2005). Proposed property types and minimum specifications.
- Un-Habitat (2005). Financing Urban Shelter - Global Report on Human Settlements.
- NHFC (2003). Reasons for non-payment of mortgage loans and municipal services.
- Fannie Mae (2004). Low income housing loan servicing: South Africa. Report prepared for the FinMark Trust.
- Business Day. Banks urge state to share the risk. 16 March 2006
- Sunday Argus. Credit Bill Aims to Pull Loan Shark's Teeth. August 14 2005
- Financial Sector Charter, October 2003

***Interviewees***

- Rudolph Willemse, Home Loan Guarantee Company
- Jopie van Honschooten, Banking Association of South Africa
- Willie Vos, SAMLC
- Pierre Venter, ABSA Bank
- Annette Carstens, Tracy Ferdinandi, Glen Pratt, Standard Bank
- Sibusiso Ndlovu, Abel Mngadi, FNB
- Michael Dalby, Vizier Advisors
- Anushka Ramlall, Pieter Van Heerden, Nedbank
- Tlhoriso Thelejane, Dr Lux Ariyan, NHFC