2012

Action Learning Project

UNSECURED LENDING

What Is The Future Of Unsecured Lending For The South African Financial Services?

SYNDICATE GROUP IV

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EXECUTIVE SUMMARY

Unsecured lending portfolio has grown at an average annual rate of 25% since 2005, from R34 billion in 2005 to R126 billion at the end of 2011. It now accounts for 8% of total retail credit book compared to 4% in 2005. Unsecured lending, specifically personal loans were mostly marketed to the low income earners in the 1990s. The profile of customers taking up personal loans has changed over time. Various commentators and government representatives recently expressed concern about the rapid growth of this portfolio over the last few years.

Informed by local and global research, this Action Learning Project identified the driving factors behind the rapid growth in unsecured lending, outlined the risks and opportunities going forward; provided a future outlook on the subject matter and recommendations for the banking sector. Our research highlights key drivers of unsecured lending from a demand and supply perspective. Key demand side drivers include the increased take up of this product by the middle to high income household market since 2007. Migration of low income households into the middle income level due to increased discretionary income and increased take up of debt consolidation product also contributed to the growth in this segment. We also note that more consumers have exited the informal and unregulated micro finance market and moved into the formal banking system.

Supply side drivers were in the main influenced by introduction of the NCA in 2007 that made unsecured lending more attractive from a margin perspective than secured lending products. The attractiveness of unsecured lending, coupled with the reduced returns on secured lending resulted in entrance of new players and increased focus by existing players. The review of maximum loan size and term of debt resulted in larger size loans and longer repayment period, attracting new customers and increasing cash flow affordability for consumers. The pending introduction of Liquidity and Capital rules under Base III resulted in banks embarking on portfolio tilt strategies that favoured short term debt over long dated term due to increased funding costs associated with long dated debt.

We believe that there will be market correction in the short to medium term due to increased competition, changes in macro- economic environment and changes to the regulatory framework. We conclude that the rapid growth fuelled by the middle to upper income households is not sustainable and will normalise to single digit growth in the short term. However, we also highlight the fact that current analytics around risk management indicates that credit quality of unsecured lending remained stable or improved in the last 5 years, notwithstanding some level of consumer stress. Importantly we emphasise the fact that lending to lower income groups has remained flat over period under review. We proposed revised lending principles for the lower income groups to allay fears raised by stakeholders in government and social groupings.

We conclude that current growth in unsecured lending does not pose undue risk to the banking system in the short term based on the analysis mentioned above. We also believe that there will be opportunities for the industry to attract new customers and manage current relationships in a

profitable way. We conclude by listing key recommendations on managing potential risks in unsecured lending going into the future.

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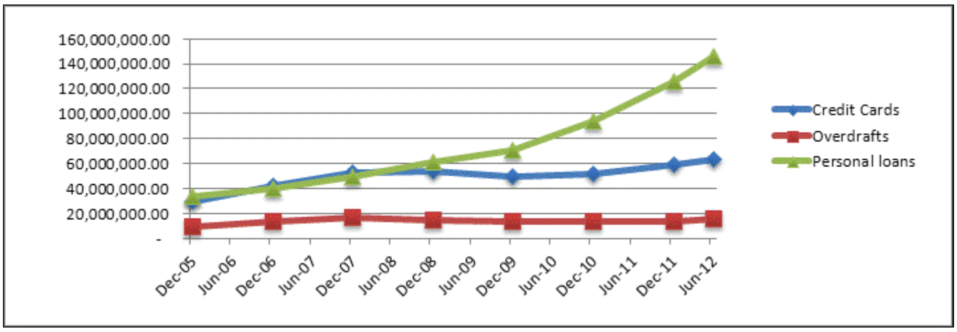
Scope of project

Context

Financial publications in South Africa have put unsecured lending in the spotlight (Whitfield, 2011) as the National Credit Regulator (National Credit Regulator, 2012); the South African Reserve Bank (Reuters, 2012) and government officials (Mittner, 2012) question the unsecured lending growth that has taken place in the recent past.

When concerns were raised in the market regarding the rapid growth in unsecured lending, the size of the credit market at 4th quarter 2011 was R1.32 trillion of which mortgage loans comprised approximately 50% (R700 billion). The size of the unsecured credit market at the end of quarter 4 2011 was R270 billion, which comprised 8% of the credit market (National Credit Regulator, December 2011). The year on year growth in unsecured lending to individuals as at 4th Quarter 2011 was 26% (South African Reserve Bank, 2012) and the average year on year growth from 2005 to 4th Quarter 2011 was 19%.

Graph A below illustrates that the product growth in unsecured lending to individuals is primarily in the personal loans segment, which grew at an average rate of 25% from R34 billion as at December 2005 to R126 billion as at December 2011 (South African Reserve Bank, 2012):



Graph A: Product growth in unsecured credit – individual / household sector

In response to the growth in unsecured lending over the last 6 years, the South African Reserve Bank and National Credit Regulator have indicated that they will monitor the trends in the unsecured lending market. The South African Reserve Bank has asked retail banks to clarify the factors driving the growth in the market and to provide more details on the components of the lending. The National Credit Regulator has also commenced research on the increase of unsecured credit lending in South Africa. The significance of these parallel investigations is that regulatory changes may arise due to the findings on the factors driving the growth rate.

Problem statement

This Action learning Project (ALP) aims to identify risks and opportunities that the unsecured lending market may present to the banking sector in the next 3 to 5 years, and recommendations will be made on steps or actions to mitigate such risks and/or capitalise on the opportunities.

The starting point will be to consider the growth of unsecured lending in South Africa over the last 6 years and to determine the factors that drove such growth from a supply and demand perspective. Once these growth drivers are identified, a finding will be made as to whether the growth seen in unsecured lending is sustainable and if so, what the unsecured lending market may look like over the next 3 to 5 years. Thereafter, we will consider risks and opportunities that may arise in relation to unsecured lending over the next 3 to 5 years, and make recommendations as to the mitigation of and/or maximisation of such risks or opportunities.

1.1.1. Definition of Unsecured Lending

The Federal Trade Commission defines unsecured lending as a debt that is not tied to any asset. In this ALP, unsecured credit is considered to be credit that is not collaterized by any assets to which the creditor can have recourse in case of failure by the debtor to meet the credit obligations. The South African Reserve Bank views the following products as forms of unsecured lending:

Credit card;

Overdrafts;

Personal loans; and

Financing provided to Small to Medium Enterprises.

1.1.2. Exclusions

1.1.2.1. Credit modelling and methodology, as this is viewed as proprietary for each Bank;
1.1.2.2. Overdrafts and loans issued to the public sector as listed below;
1.1.2.2.1. Local, provincial and central government.
1.1.2.2.2. Social security fund.
1.1.2.2.3. Development Finance Institutions.
1.1.2.2.4. Public non-financial sector (such as Transnet; Eskom and Telkom).
1.1.2.3. Factoring Debtors; and
1.1.2.4. Overdrafts and loans issued to the corporate sector.

1.1.3. Research Process

Qualitative research methodology, specifically interviews, was used to explore attitudes, behaviour and experiences of stakeholders.

The following prescriptive process was being followed:

Identified the ‘target grouping’, being the stakeholders that we intended to focus this research on.

They were:

- South African Commercial Banking Executives;
- Credit experts and analysts;
- Independent regulators (National Credit Regulator and South African Reserve Bank);
- Industry Associations (Banking Association); and
- Economist.

Research design:

- Gathered primary data using the interviews.

Comparative research:

Finance solutions developed by banks in Uganda and the United Kingdom were considered, together with the risk management and regulatory framework in which the foreign banks are governed. Any inferences derived from the comparative research were qualified with reference to what is known about the relevant contexts.

1.1.4. Roles and Responsibilities of Team members

The team members have collective responsibility for the ALP. The following three key roles have been defined and assigned to specific team members with the remainder focused on research:

Project Manager – Joseph Masekoameng

- Manages project meetings;
- Co-ordinate activities; and
- Enforces and ensures discipline and compliance with charter and project agreement.

Scope Manager – Anesa Dindar

- Ensures compliance with agreed scope and brief; and
- Research – ensure compliance with scope and brief.

Quality & Assurance Manager: Toyin Oladiran

- Ensures correctness and cohesion of writing; and
- Ensures correctness and cohesion of referencing.

1.1.5. Problems or Constraints Encountered

1.1.5.1. There was limited access to statistics and information in relation to banks’ lending practices.

1.1.5.2. Due to time, practicality and cost constraints, interviews of representatives of the South African financial sector were limited to the Gauteng Province. Telephone interviews were conducted where physical meetings were not feasible.

Research

The qualitative research methodology was used in that primary data was gathered through interviews in order to explore attitudes, behaviours and experiences of stakeholders. We chose qualitative research over quantitative research since we needed a research method that is open to contextual interpretation and not based on statistical analysis or hypothesis testing.

Qualitative research allowed us to work with a small but focused sample and allowed for flexibility and responsiveness in interviewing. The research instrument appears as Annexure 1.

2.1. The stakeholders that were interviewed are:

2.1.1. South African Retail Banking Executives

African Bank: Errol Van Der Merwe (Head of Products) and Marcus Borner (Executive: Balance Sheet Management)

Nedbank: Gavin Payne (Executive Head Retail Risk)

First National Bank: Christoph Nieuwoudt (Chief Risk Officer)

ABSA: Gerret Oosthuizen (Personal Loans Product Specialist), Ajay Naranjee (Product Manager - Personal Loans Product Solutions) and Tobi Willemse (Economist)

Standard Bank: Khetha Mazibuko (Head Inclusive Banking) and Andrew Van Der Hoven (Head Personal Unsecured Lending)

2.1.2. Non Banking Credit Providers

Direct Axis: Mark Finlayson (Managing Director)

Credit experts and analysts: Harry Botha (AVIOR – Equity Analyst: Banking)

2.1.3. Independent regulators

National Credit Regulator (attempts were made to interview NCR representatives but to no avail. Secondary research from the NCR was thus relied upon)

South African Reserve Bank: Rene Van Wyk (Registrar of Banks)

2.1.4. Industry Associations

Banking Association: Cass Coovadia (Chief Executive Officer)

2.1.5. Economists

Intellidex: Steward Theobald (Economist/ Journalist)

In order for the results to be more meaningful, sufficient representatives from each stakeholder group were interviewed. In total, approximately 14 representatives of different stakeholders across the industry were interviewed.

2.2. Secondary data was obtained through desktop research from reputable academic, industry and regulatory sources.

Comparative international research

2.3. <u>Uganda</u>

The Ugandan social and economic context is quite distinguishable from the South African one. It is therefore not surprising that the financial sectors in these two countries differ significantly. Specifically with regard to unsecured lending, the view of this ALP is that in Uganda, though lending to households and individuals grew by 40.4% in 2011 (Bank of Uganda), reversing the decline of 11.8% in 2010, there remains a much greater focus on unsecured loans to small businesses, as opposed to individuals. Unlike in South Africa where individuals have a huge appetite for unsecured credit to fund life style costs, in Uganda, unsecured credit is sought and advanced for small to medium enterprise needs such as start-up and working capital, cash flow, production costs. This may be because of the high unemployment rate and poverty levels as a result of which many people, including employed people, run small businesses as a source of primary or secondary income.

In Uganda, financial service providers have a good understanding of social dynamics in Uganda and have developed good delivery models and products for this market. Microfinance institutions deliver services to a broader market including rural areas of the country. Financial assessments are based on peer review mechanisms where local community forums/leaders validate requests for finance to individuals/groups.

Customers understand different products offered by the financial institutions due to the high literacy rate in Uganda and also due to customer training provided free of charge by most financial institutions. In this regard, it should be mentioned that lenders in Uganda tend to have an intrinsic value set that aims to uplift society particularly the rural society. Banking products have a social responsibility flavour and include products such as group loans with built in savings plans, education loans and small business loans.

One similarity between South Africa and Uganda as far as providing financial services to low income market, is that micro lenders have been the dominant players in this market and bigger, more formal such as the big retail banks are seeking to grow in this market due to perceived higher returns. In Uganda however, the micro finance industry has penetrated the rural communities quite extensively, providing access to group loans and savings plans. The model relies on the establishment of intimate relationships with consumers through community engagement. Bigger and more formal financial institutions that are growing in the unsecured lending market in Uganda also have to find alternative and cheaper channels other than traditional brick and mortar branches.

The Table below summarises the comparisons between the unsecured lending market in Uganda and that in South Africa.

	South Africa	Uganda
Factors/Use	Individual, mostly for consumption	Productive purposes .i.e. businesses
Process	Bank process fully automated .i.e. Application and credit behavioural scoring. National identification system. Credit Bureau	Manual process. Relationship and trust based. Community validation, no national ID system. New credit bureau still to be developed
Demographics	Mostly low income, no other concentration	Mostly rural, agriculture sector with strong women involvement
Size of loan	Average of R9 000 with tenure of 84 months	Average of $50 with tenure up to 36 months
Legislation	NCA and Consumer Commission protects clients	Free market with no consumer protection. Industry regulates itself
Profits	ROE up to 25% for smaller player, up to 20% for bigger banks	ROE above 30% across players
Debt Collection	Formal debt collection systems	No formal debt collection systems. Financial institutions rely on the consumer-groups to manage their own collections (peer pressure). Financial institutions provide financial literacy training to clients
Interest rates	Regulated	No interest rate regulation by the Central Bank

2.4. United Kingdom

The May 2012 Bank of England credit conditions survey indicates that the availability of unsecured credit to households increased slightly in 2012 Q2. The demand for credit card lending was reported to have decreased over the same period while the demand for other unsecured lending had increased.

The survey also indicates that default rates on total unsecured lending had decreased in Q2 2012.

2012 has seen a steady decrease in the rates lenders charge for personal loans. Banks, building societies and other lenders, like supermarkets, have once again started competing aggressively for new unsecured lending. The Bank of England's statistical release in May 2012 shows that total lending to individuals rose by £1.4 billion in April 2012, in line with the previous six-month average. The twelve-month growth rate was unchanged at 1.0%.

According to the latest quarterly UK Family Finances report from Aviva, there has been an increase in unsecured debt and mortgage debt, while savings levels have continued to stall. The average amount that families in the UK borrow through credit cards, personal loans and overdrafts has shot up between May and July 2012, rising from £9,314 to £10,563. At the same time the typical family's savings fell to £1,131 from £1,228 over the same period.

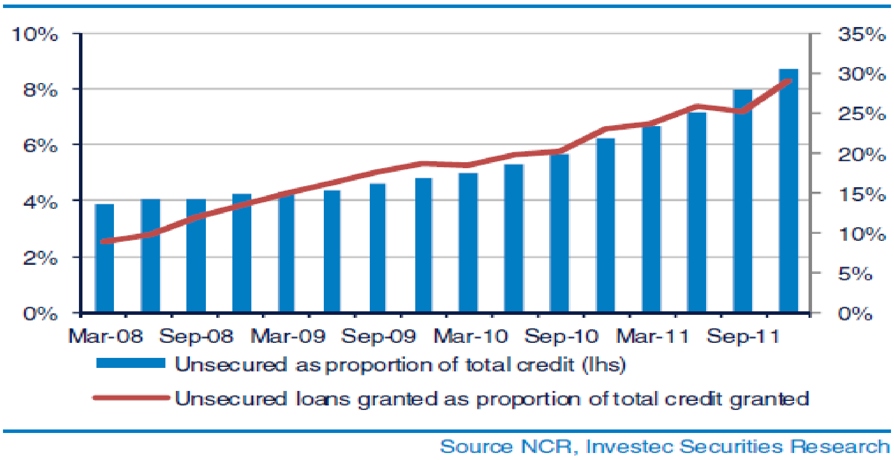
The Office of Fair Trading in the UK monitors the granting of credit since there are situations where credit can be damaging for a consumers' welfare. It is believed that promoting competition amongst lenders will be more beneficial than imposing price controls and that over-strict regulation can lead to unmet demand for credit being met through illegal lending. In February 2012 the OFT announced that they would be reviewing the pay day loans sector to check compliance to the Consumer Credit Act 1974 and its guidance on responsible lending. 8 loan companies surrendered their license or withdrew their license application following the OFT's investigations.

Growth in unsecured lending – current reality

Credit Market

Unsecured credit has been growing at a far higher rate than secured credit, more so since the implosion in the mortgage market in 2008. Whilst unsecured lending accounted for 4% of total retail credit in 2008, it now constitute 8% of total retail credit as at the end of Q4 2011.

The graphs below show that the rate of growth in unsecured credit granted since 2008:



Graph B: Rising Unsecured Lending

Change in Regulatory Framework

Certain changes in the relevant regulatory framework have resulted in an increase in the supply of unsecured lending products by the formal sector.

<u>National Credit Act</u>

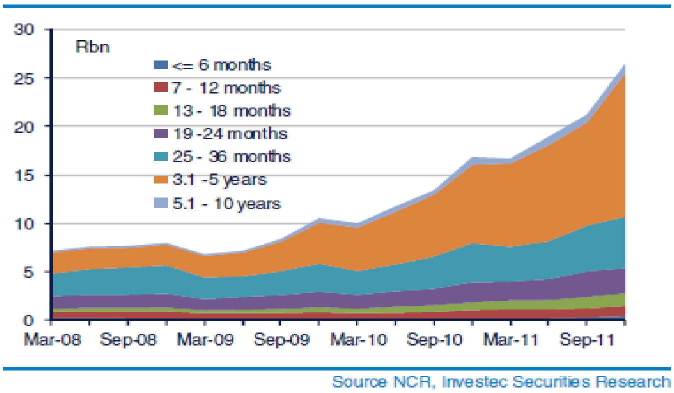
The need for a review of the consumer credit legislation was recognised pursuant to the 1994 review of the Usury Act (Usury Act 73 of 1968). Some of the criticisms of the credit market pre the National Credit Act (NCA) were:

- ineffective consumer protection, particularly in relation to the 85% of the population in low income groups;
- high cost of credit and for some areas, lack of access to credit;
- rising levels of over-indebtedness;
- reckless behaviour by credit providers and exploitation of consumers

The NCA was enacted to establish pillars for the purpose of credit consumer protection, one of which was the prescription of maximum rates and rate calculations.

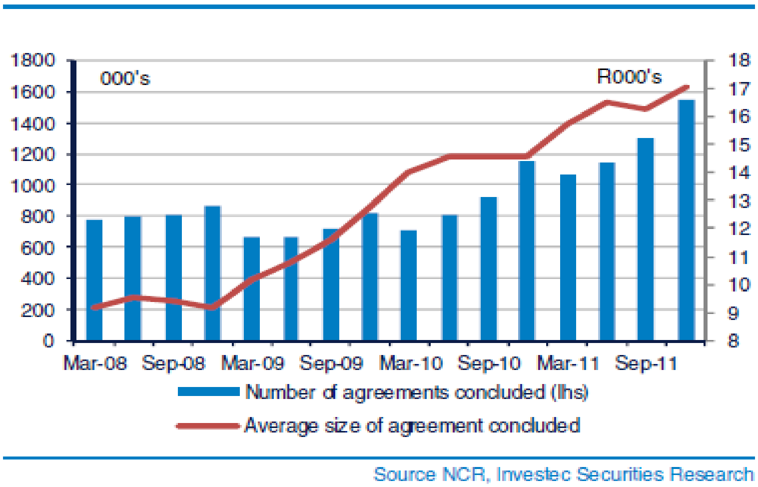
According to the NCA (Regulation 42(1)), the maximum prescribed rate for unsecured lending permitted in terms of the NCA is calculated annually by taking SARB's ruling Repurchase Rate times 2.2 plus 20% per annum as well as the minimum initial and service fees. Initiation fees are capped at 15% of the loan amount and the service fee is capped at R57 a month for the full loan period. This is distinguishable from mortgage agreements where the maximum prescribed rate is calculated annually by taking SARB's ruling Repurchase Rate times 2.2 plus 5% per annum, and credit facilities and other credit agreements where only 10% is added per annum.

The NCA as contrasted with the Usury Act, allows for more attractive margins and longer loan terms, which makes unsecured credit more lucrative for banks. The amount of growth which the major commercial banks are recording in the personal loan segment implies a high level of return on equity and a high level of earnings growth. Pre-NCA the maximum permissible loan size was R10 000 and post NCA the loan size has become a function of customer affordability with no maximum limit set for unsecured lending. The tenure of loans has also increased from 36 months to 84 months, making repayment of loans more affordable. The impact of these changes is reflected in the increase of long dated debt since 2008 as more consumers opt for terms of 36 months or more.



Graph C: Term of Unsecured Lending Credit Granted

Statistics by the NCR indicates that loans with tenure of 3 years or more accounted for 28% of unsecured loans at the end of Q4 2007; that contribution has increased to 56% as at Q4.



Graph D: Unsecured Credit Granted – Number and Size per quarter.

The graph above shows the impact of the increase in the average size of new unsecured loans granted since the lifting of the ceiling on the maximum loan by the NCA. The average size of unsecured loans grew from R9000 during Q1 2008 to R17 000 at the end of Q3 2011, contributing to growth in average balances for this portfolio.

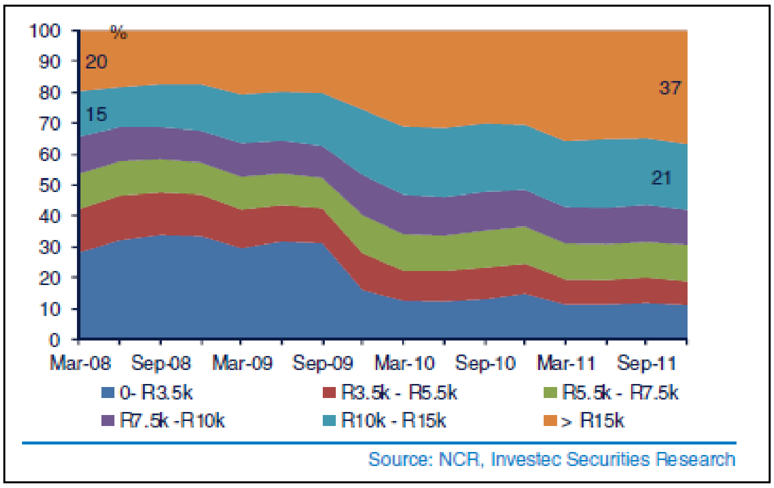
Basel III

The proposed changes under the Basel III Accord will raise capital requirements for banks. Liquidity requirements will become stricter and banks are now focused on portfolio tilt strategies that include reducing exposure to the mortgage market and applying capital on the most efficient and profitable products. Focus has shifted from long dated debt to short dated debt like unsecured lending. Short-term loans are attractive from a liquidity matching and funding perspective as there is more funding available to support this type of lending. Banks were previously allowed to fund long term products through a mix of deposits, including short term retail deposits, something which is restricted under the Basel III.

Demand Factors

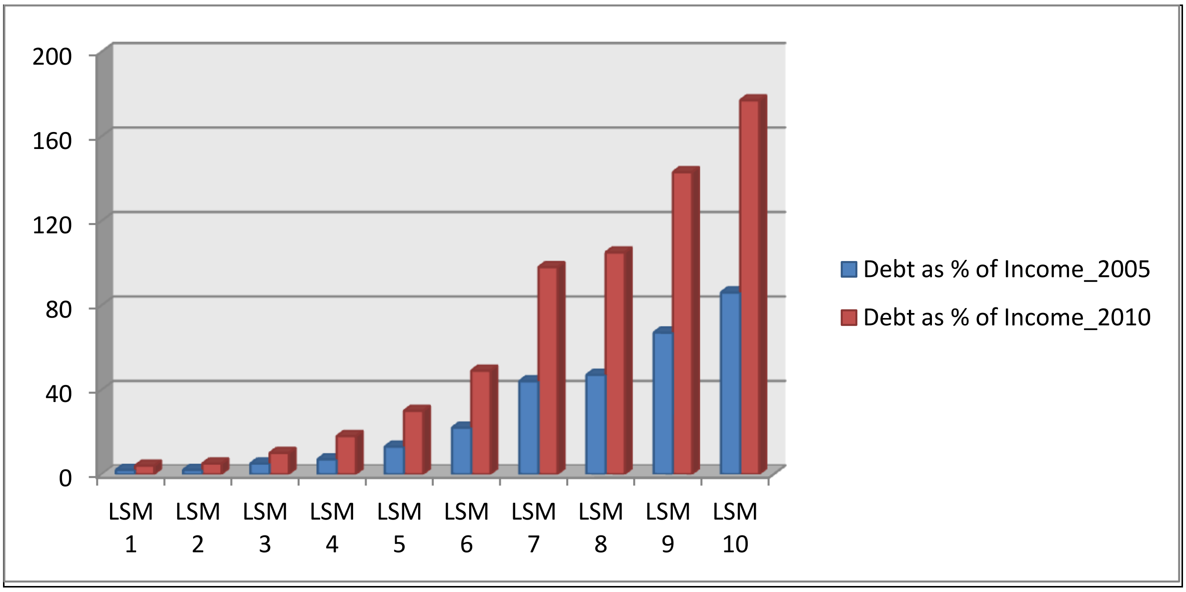
<u>Demand driven by middle income earners</u>

Statistics by the NCR indicates that households earning from R7 500 per month to over R15 000 per month accounted for 69% of unsecured loans granted at the end of Q4 2011. There has been a surge in unsecured facilities taken up by this income groups since Q4 2008 with income group earning R15 000 and more accounting for 37% of unsecured loans as at end Q4 2011 relative to 18% as at Q4 2007, a staggering growth of over 105% over 4 years. Whilst traditionally the unsecured lending space has been perceived to be a low income market, we have seen a significant drop in the new business written for households earning up to R7 500 per month, from 58% as at Q4 2007 to 31% as at Q4 2011. Households earning up to R3 500 per month now accounts for only 11% of new business written relative to 33% of new business at the end of Q4 2007. As a result of the analytics done above, we believe that the rapid growth in unsecured lending was primarily driven by the credit appetite of the middle to high income earners as the housing boom reached its peak and this income segments replaced secured debt with unsecured debt to fund consumption and switch to a product previously perceived to be a product for the poor/low income groups.



Graph E: Proportion of Unsecured Credit granted by monthly income

Graph F below indicates the debt to disposable income distribution by living standard measure (LSM) since 2005, further confirming the correlation between growth in unsecured debt to LSM 7 – 10 groups and the increased debt burden faced by this income groups. It also confirms our view that whilst the lower LSM groups have limited funds for debt, they still have capacity to leverage going into the future.



Graph F: Debt to disposable income level by income bracket in South Africa

Migration of low income households from unregulated markets

Whilst traditionally unsecured lending relating to personal loans was successfully marketed to the mass markets, it was not enough to close the gap in the informal and unregulated micro lending environment 'mashonisa/ money lenders' that operated in the low income areas. It was until recently that all the major banking institutions opened up to the previously unbanked through smaller branches, kiosks in retail shops and loan centres. The increased marketing drive resulted in more low income earners taking up variety of products marketed by the banks .i.e. funeral policies, credit life policies and personal loans. People who previously had no access to the formal banking system are now able to access these services. Coupled with this is the fact that there has been a demographic shift in the country with some low income households experiencing real income growth as a result of various private and public sector initiatives to address past social imbalances. These households migrated upwards to the middle and upper income categories, enabling them to increase their credit appetite.

Debt consolidation

Debt consolidation is now available to consumers as an option. Consumers seek both convenience (one loan rather many) and improved monthly cash flow (due to e.g. term extension); and ability to consolidate several existing loans facilitated by increase in unsecured loan values granted.

Business Case

We undertook an In-depth research to understand the factors that influence the performance of unsecured lending. The factors identified are relevant irrespective of time, based on the economic principle of supply and demand. This enables industry stakeholders to predict the future of unsecured lending through scenario planning.

Our opinion is as follows:

Regulation

We do not expect significant regulatory changes to the National Credit Act (NCA) but rather a focus on enforcement and operational changes. With regards to operational changes we believe that the National Credit Regulator (NCR) will no longer report to the Department of Trade and Industry but rather the Treasury Department through the Financial Services Board. This is aligned to the "twin-peaks" model that the British regulator has deployed to manage market conduct and is viewed as a key enabler to the Treasury policy document titled "A safer financial sector to serve South Africa better".

In the “twin-peaks” model all prudential regulation and supervision will be under one agency, meaning the financial soundness of all banks, insurance companies and securities firms is supervised. The second peak will oversee the market conduct regulation and supervision, thus focus on customer protection on financial product purchases and the entrustment of funds to financial institutions. We expect this transition will commence in 2013 with applicable legal amendments and only be felt within the industry in 2014.

The NCR is entrusted in upholding the NCA thus has the responsibility to enforce and protect credit consumers. It is for this reason that we expect the NCR to increase its surveillance presence to identify unregistered credit providers, illegal lending and collection practices while also auditing affordability assessments. This enforcement will be across all lenders being banks to micro lenders, allowing for the playing field to be levelled. This could also have a social impact on consumers that cannot be serviced in the formal credit market unless regulation creates a commercial incentive for this riskier market to be served.

In April 2012 the NCR commenced an investigation into the unsecured lending growth with the intention to better understand the driving factors. From the analysis we have conducted we expect the NCR to concur with our findings on the supply side and demand side factors. We believe it would be unwise to make dramatic changes to the NCA to slow down growth but rather use the existing tools available, namely the maximum term of credit, the interest rate calculation, the maximum loan size and the affordability assessment calculation.

Demand factors

Migration of low income consumers

We believe that there is a sizeable number of low income earners still conducting their banking activity in the unregulated micro finance environment. These consumers will in future migrate from the informal system to formal channels, further contributing to growth in this segment. We cannot overstate the importance of bringing these consumers into the regulated market to ensure that they have access to fair and safe banking environment. The exploitation of consumers in the informal segment is well documented. It is highly unlikely that the money lenders will be completely eradicated from the social space for as long as the formal system does not relax some of the banking rules to cater for this market, however, government working closely with the banking sector can facilitate the migration of vulnerable consumers into the formal banking system.

We are also of the view that structural changes in the economy will result in more households migrating into the middle class as they empower themselves through quality education and skills.

Growth in real income at the lower end of the market presents further penetration opportunities for unsecured lending. We discuss elsewhere in this paper on how to manage associated risks and opportunities.

Household debt

The middle to upper income earners generally have exposure to various debt .i.e. mortgages, vehicle finance, credit cards/ overdraft amongst others whilst the lower income segment has traditionally not qualified for other debt than personal loans. It is therefore logical that household debt to income in the upper LSM groups is very high relative to the lower LSM groups.

Our view is that there is limited upside for unsecured lending in the upper LSM groupings, particularly LSM 7 to 10 due to high debt ratios in that category. We see potential for further growth in unsecured lending in the lower income segment as a result of new jobs created in the public sector, coupled with the fact that the debt ratios are extremely low in the low income segment (LSM 1 – 4). We believe that various government initiatives to create jobs may result in improved job opportunities in the unskilled jobs market .i.e. extended public works programmes (EPWP), job funds, ESKOM, infrastructure spend etc., with focus on use of unskilled labour.

We are aware of the downside risk to the credit market due to the interest rate cycle. Our research indicates that we are probably at the bottom of the interest rate cycle and rates should start increasing in the short to medium term. The middle to upper income households are most likely to feel the pinch of rising interest rates as they are exposed to multiple debt products. Whilst personal loans are mostly priced on a fixed rate basis, some clients are exposed to variable interest rates on mortgages, car finance and other revolving short term debt. It is against this background that we believe the industry will have to tighten up credit criteria for the middle to upper income segment by adjusting the credit scorecards to take the stress test scenarios into account .i.e. next interest rate levels, negative real income growth for high earners, inflation outlook as this will have a material impact on the highly indebted consumers. This segment has in the most fuelled the growth in unsecured lending. We do not believe that the current penetration and growth rates in this segment are sustainable and will start to slow down in the short to medium term.

Understanding use of disbursements

Following on interviews with industry players, we sought to understand how consumers used disbursements from personal loans. Statistics around use of funds are informed by data supplied by consumers when they apply for loans. The only mechanism that could verify the use of funds would require the industry to control disbursements of funds, which may result in increased administration costs.

We believe that the volume of payouts across the industry is too high and it would therefore be impractical from a cost perspective to justify a system that disburses funds to suppliers who are rendering a service to clients .e.g. client applies for a R30 000 to build a swimming pool, there are 5 suppliers involved in providing a service to 1 client, the administration costs are exorbitant for such a system. However, we acknowledge the need to have some level of understanding on how consumers use funds obtained through personal loans, especially in the high risk category of debt consolidation and debt roll over. Data on debt consolidation products/ debt roll over is available at company analysis and it will be useful for the industry to quantify level exposure to this type of 'products'.

We believe that the credit vetting processes must be robust enough to dilute the risk of uncertainty around the use of funds approved for personal loans. Understanding customers and lending responsibly should address some of the challenges around disbursements.

We are as concerned about use of funds for consumption, funding lifestyle or refinancing consumer debt but we believe that there is other positive use of funds .i.e. funding of homes in rural areas/informal settlements through personal loans as there is lack of title deeds for this type of housing. Other households are using the funds for home improvement or education and funerals. We do acknowledge that the level of sophistication and financial literacy differs for each income segment and as such there is an inherent risk associated with each income group. It is against this background that we recommend caps on debt levels to the low income groups, conservative credit criteria and continuous financial education initiatives focusing on the lower income segment.

We would also like to acknowledge the fact that some institutions have been operating in the personal loans segment for 10 to 20 years and have built through the cycle experience of this market over time. This experience should add value to the risk management practices in this environment going forward.

Supply factors

The supply side drivers have been a key component to the growth in unsecured lending with the accessibility to capital locally and internationally having been relatively easy to obtain due to stagnating international markets recovering from the financial crisis. With investors searching for better returns, emerging markets are attractive with above average GDP growth and a higher interest rate environment compared to the developed market. These factors incentivize investors to avail funds for lending purposes as they result in a healthy return on equity. The caveat to raise funds in the capital markets is the sovereign rating of the country and the financial institutions credit rating. These have recently come under the spot light due to the Marikana incident and the down grading of South African debt and banks.

With increasing capital adequacy requirements through Basel III and improved liquidity matching techniques, banks and lenders are finding increased comfort in tilting their balance sheet towards unsecured lending, while also being attracted by the opportunity for improved profitability.

It is for these reasons we can expect to see the entrance of new credit providers through existing retail distribution channels e.g Cash Converters and even unique innovative credit providers e.g. Wonga. Industry consolidation can also be a major consideration point as distress is experienced on certain books allowing for cash flush and specialized lenders to obtain credit books at a discount.

Does the rapid growth in unsecured lending pose a systemic risk to the banking sector?

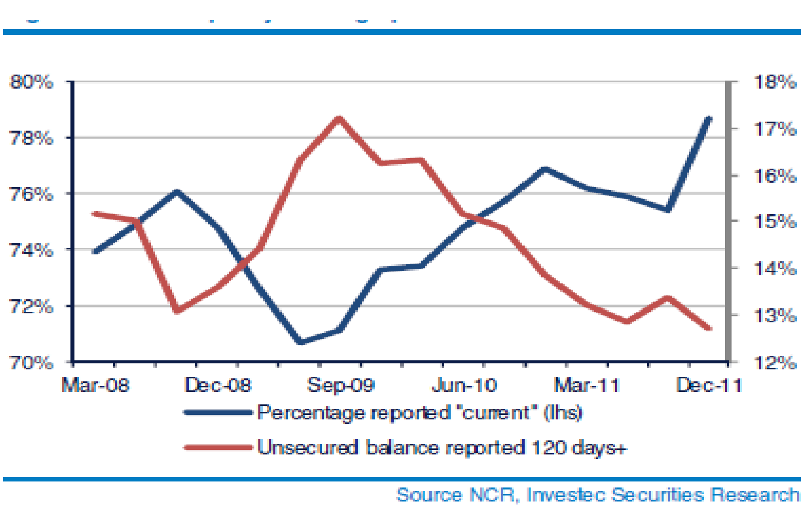
Our analysis has highlighted the following key trends that will inform our view of the risk associated with recent rapid growth in unsecured lending:

- Most of the new debt has been taken up by the middle to income earners. Whilst the debt to disposable income ratios for this group are high, debt serviceability remains stable, although there are signs that credit health may be deteriorating;
- Low income groups have marginally contributed to the growth in unsecured lending but we appreciate the concerns raised by government on impact of unsecured lending on this income group but believe that there should be a balanced view on how best to service this market going forward;
- The financial institutions have taken the lessons of the financial crisis into account from pricing for risk perspective and as such have priced the unsecured loans for the associated risk;
- Some of the inherent risk .i.e. retrenchment, death, disability are priced into the product and as such reduce overall risk relative to some of the unsecured lending;
- Major banks are in the most lending to existing customers with acceptable credit history, and have robust credit scorecards and collection strategies
- Most of the institutions have a through the cycle credit risk management history dating back to the early 1990s.
- Unsecured lending constitutes only 8% of total retail credit in South Africa

There was a decrease of 3.2% in the default rate from 11.63% pre-NCA (2005) to 8.41% post NCA (2008) (Rossouw, Zelna, 2008). As such, the statistics indicate that it cannot be said that there is a disproportionately high increase in the rate of default as compared to any increase in the rate of growth of unsecured credit.

Our research indicates that the credit quality of the unsecured lending book has remained stable over the last 4 years, with the Non-Performing Loans (91 days+ in arrears) relative to the total unsecured lending book reducing from 15% at the end of Q4 2008 to 14% at the end of Q4 2011. The trends in the early arrears book/ Watchlist (1 – 90 days in arrears) have tracked similar trend dropping from 10% of the book at end of Q4 2008 to 7% at the end of Q4 2011.

The graph below indicates that notwithstanding the extensive growth in unsecured lending, credit quality has remained constant over the last 4 years.



Graph G: Credit Quality – Current VS 120+

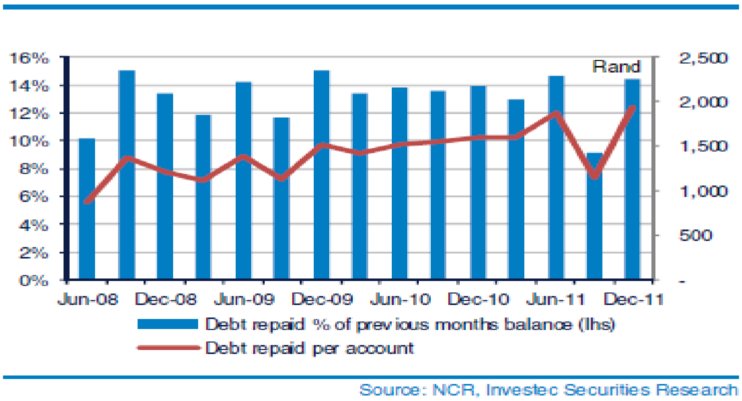
The table below indicates the value of outstanding debtors by risk bucket over time and asserts the view that the unsecured lending book has not yet deteriorated to an extent that alarm bells should be raised.

	Q42011		Q42010		Q42009		Q42008	
Current Book	R88bill	79%	R56,7bill	77%	40bill	73%	35.8bill	75%
Early Arrears	R8bill	7%	R5,8bill	8%	4,9bill	9%	4.8bill	10%
Non-Performing	R16bill	14%	R11,2bill	15%	9,6bill	18%	7.2bill	15%
	R112bill		R73.7bill		R54.5bill		R47.8bill	

Source: NCR – unsecured lending outstanding debtors by risk bucket

The capital repayment burden on consumers is certainly growing. However, the table below indicates that the level of debt repaid per quarter has remained stable. The average repayment per quarter per account has increased steadily from R1 000 per account in June 2008 to around R2 000 per account in December 2011. Overall, the credit quality of the unsecured loan portfolio does not appear to be reducing. Although the unsecured balance > 120 days overdue has increased to R14.4 billion from R6.4 billion in March 2008, the percentage of the overall book in this category has fallen to below 13% for the first time in the date series (and from over 17% in September 2009).

The quarterly repayment made by customers on the entire consumer credit book of R1.269 billion has increased from R53 billion in June 2008 to R79 billion in December 2011, a 49% increase.



Graph H: Stable Unsecured Lending Repayments

Total credit growth has slowed down since the financial crisis of 2008. Most affected has been the mortgage market that has historically accounted for over 50% of the total credit market in South Africa. As a result, financial institutions have focused on growing profitable business in new markets, unsecured lending being one of the focus areas for new growth. Historically unsecured lending, specifically personal loans; has grown at a low rate with demographic bias towards the mass market. One could therefore argue that the repositioning of the product on the back of the regulatory changes and general banking conditions resulted in the rapid growth over the last few years, off a relatively low base.

The contraction in the vehicle and mortgage market due to macro-economic changes has also contributed to the rebalancing of the total credit market in the last 5 years. Whilst the banks increased focus on this market, it did not relax the underlying credit criteria. As with other products, banks continually adjust credit scorecards to respond to change in macro-economic environment and overall risk in the banking environment. We expect the approach to continue as market correction happens in the unsecured lending area .i.e. employment numbers, inflation, interest rates and consumer confidence. The growth rates experienced in earlier years will slow down in the short to medium term as the market penetration levels for unsecured lending gets to a saturation level.

The analytics covered elsewhere in this paper indicates that there has been no material deterioration in the unsecured lending book over the last 5 years and the industry has been pro-active in managing risks associated with this portfolio.

It is against the above background that we do not believe that the recent growth in unsecured lending poses an undue risk to the banking system in the short term.

Recommendations

Following extensive engagement with local and global experts, and based on comparative research done for the ALP, we recommend the following:

- Keep most of personal loans on a shorter term to reduce concentration risk and increase ability to collect out of the loan. Shorter term loans affords the industry ability to effectively reallocate capital when macro- economic conditions change;

- Establish credit limit for personal loans based on income multiples by income group; with stricter multiples for low income groups to reduce disproportionate spend of disposable income on debt rather than necessities. We further propose a cap on credit limits for low income earning groups; notwithstanding ability of customers in that segment to afford higher facilities. It is in this regard that more engagement must happen between the regulator, banking industry and the government;

- Whilst South African banking system is acknowledged worldwide for being a leader in risk management; the industry needs to continually improve and build robust credit assessment and collection management tools and infrastructure;

- The industry needs to build and share data on customer segmentation, especially on the lower income segment.

- Transactional banks should primarily focus on their own transactional customers as that enable banks to correctly build credit scorecards based on customer behaviour and thus assess risk more accurately.

- Banks should as part of broader financial literacy initiatives; develop products that encourage saving. Continuous consumer education and information will provide customers with a better understanding of the credit products, which would enable them to make informed decisions.

- Whilst statistical evidence indicates that the growth in unsecured lending was driven by middle to high income earners; there is a persistent negative public perception that the industry has been reckless and exploitative in lending to the lower segment. The industry needs to communicate the correct position in a far better way and re-affirm the fact that they have extended funding to the lower income groups in an ethical and fair manner. The industry needs to also emphasise the fact that more people have migrated from the informal banking sector to a regulated and safe environment than in the past.

- Banks must effectively manage the customer data to improve product offering through cross-selling opportunities, matching correct products to customer needs.

- Banks should incentivise low risk customers to switch to personal loans by sacrificing some level of margin and fees. Industry to ensure that low risk customers are not cross subsidising high risk customers. This will attract new type of customer to this segment and bring concentration balance into the portfolio.

- Credit Bureau agencies need to invest in real time IT infrastructure to ensure that there is no scope for consumers to obtain multiple loans from different institutions whilst the credit bureaus await data downloads from the industry players.

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Annexure

Non disclosure document

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Non-Disclosure Undertaking

I undertake that, in relation to information submitted or provided to me by ____ on behalf of __________________________________ [insert bank name] at the meeting held on _________________________ 2012, at ___________________________________ or in consideration for the information to be provided subsequently as a consequence of this meeting ("the information"), I will:

3.1 Not use or disclose the information except as provided for below;

3.2 Take all reasonable precautions to prevent the unauthorized disclosure of the information provided;

3.3 Not use, disseminate or publish the information for any purpose other than for the Action Learning Project on the Future of Unsecured Lending in South Africa, by Syndicate 4, WBS / BankSeta IEDP 2012 Retail Banking.

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Interview context document

WHAT IS THE FUTURE OF UNSECURED LENDING IN THE SOUTH AFRICAN FINANCIAL SERVICES SECTOR?

Context

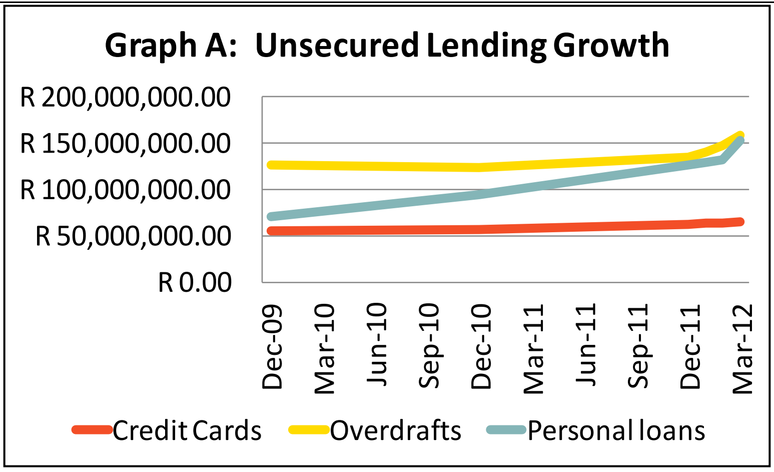
Financial publications in South Africa have put unsecured lending in the spotlight (Whitfield, 2011) as the National Credit Regulator (National Credit Regulator, 2012), the South African Reserve Bank (Reuters, 2012) and government officials (Mittner, 2012) question the growth in that area.

The total gross unsecured credit exposure by six selected banks amounted to R340 billion in December 2011. Over the same period, total unsecured credit exposure, as a percentage of total gross credit exposure, only amounted to 21% of the R1,32 trillion retail credit market.

According to the South African Reserve Bank, the highest growth in gross credit exposure to unsecured lending was in the revolving credit categories with exposures greater than R30 000, which grew at 39.8%, equating R16.7 billion. Growth of unsecured exposures less than or equal to R30 000 were at 15.6% (R7.9 billion) year on year in December 2011. Year on year growth in the six selected banks in unsecured lending was 11.3% in December 2011 (South African Reserve Bank, 2012).

In response to the growth in unsecured lending over the last 2 to 3 years, the South African Reserve Bank and National Credit Regulator have indicated that they will monitor the trends in the unsecured lending market. The South African Reserve Bank has asked commercial banks to clarify the drivers of growth in the market and to provide more details on the components of the lending. The National Credit Regulator has also commenced research on the increase of unsecured credit lending in South Africa.

Given the above background, the objective of our research is to consider the future of unsecured lending for the South African Financial Services sector by determining the key drivers of growth in unsecured lending and then, based on our findings, by determining the risks and opportunities presented by such growth. We also intend to define the actions that may be taken to mitigate the risks and capitalise on the opportunities.



Graph A provides an overview of the growth in unsecured lending for the period from December 2009 – March 2012, and it demonstrates that the growth in PLs have grown at a higher rate than the growth in credit cards and overdrafts, hence our main focus on PLs.

<u>Interview Questions</u>.

1. From your organisation's and/or personal perspective, What are the key drivers influencing the demand for unsecured debt, especially Personal Loans? Have these factors remained constant overtime in behaviour, influence and relevance or have new drivers been introduced?
2. Has there been any notable change in the behaviour of these drivers before and after December 2009? If there were any notable changes, how do these changes relate to the changes in the customers' appetite for unsecured debt?
3. From your organisation's and/or personal perspective, what are the key drivers influencing the supply of unsecured debt, especially Personal Loans? Have these drivers remained constant overtime in behaviour, influence and relevance or have new drivers been introduced?
4. Has there been any notable change in the behaviour of these drivers before and after December 2009? If there were any notable changes, how do these changes relate to the changes in the banks' appetite to grant unsecured debt?
5. From your organisation's and/or personal perspective, considering the drivers discussed above, what are the risks and opportunities that the growth in unsecured lending presents?
6. From your organisation's and/or personal perspective, how can those risks be mitigated? How can those opportunities be maximised?
7. In your view, what is the future of unsecured lending in the South African financial services sector?