# Comment on the National Credit Bill 2005

## Context in which this comment is made

*The point of departure of the Free Market Foundation's comment is that South Africa has a sophisticated financial services industry that is more or less on the same par with the best in the developed economies in terms of providing a wide range of services and products which are receptive to consumer preferences and choices. The proliferation of firms within the credit market particularly, is a manifestation of a robust industry that offers competitive products.*

*Policy makers have to take cognisance of the fact that the credit market is a very important part of the wide financial services industry in that it is an entry point for many entrepreneurs, some of whom move up to a more sophisticated level of operation, namely conventional banking. They should also ensure that whatever policies are implemented result in a progressive widening of the credit market. From the perspective of the consumer, this is the best case scenario.*

*With this in mind, the comment therefore focuses primarily on the consequences, intended and unintended, that will result with the implementation of the National Credit Bill as proposed.*

*Furthermore, the state president has dedicated the government to instituting measures that will lower the cost of doing business. The proposed legislation will prevent this from happening.*

*At a time when South Africa needs to attract foreign direct investment and stimulate domestic investment, caution should be exercised that whatever policy measures are implemented, they should send out positive signals to potential investors.*

*Underlying these views is the overriding principle that economic freedom results in economic growth. This is empirically verifiable and a number of studies attest to this.*

*Based on the evidence worldwide:*
- *Economic freedom results in the greatest and most rapid economic growth and leads to sustained improvement in all the other measures of human welfare.*
- *Governments wishing to bring about improvements in the material and non-material welfare of the people should aim to create an enabling environment that is consistent with the principles of economic freedom.*

**Johannesburg**
1sr Floor, Norfolk House, Fedsure Close 2,
cnr Norwich Close & 5th Street, Sandton
PO Box 785121, Sandton 2146
Tel: (011) 884 0270 • Fax: (011) 884 5672 • Email: fmf@mweb.co.za

**Cape Town**
1st Floor, Equity House,
107 St George's Mall, Cape Town
PO Box 805, Cape Town 8000
Tel: (021) 422 4982 • Fax: (021) 422 4983 • Email: fmf.ct@mweb.co.za

Website: www.freemarketfoundation.com

**Non Profit Organisation Registration No 020-056-NPO**

*In order to create an enabling environment for the rapid economic development of the country, the government should:*

- *Remove unnecessary regulatory and legislative barriers to entry into business.*
- *Set objective requirements in legislation and regulations.*
- *Endeavour to broaden and avoid reducing consumer choice so as to increase the range of options available to the consumer.*
- *Leave the final decisions regarding the suitability of any enterprise to consumers voting with their rands.*

Assessing the likely macro impact of the National Credit Bill 2005 on the credit market and industry in South Africa is an extremely difficult task.

The Bill in its present form is largely an enabling statute delegating to the executive (the Minister and new Credit Regulator) the ability to legislate most of the critical substantive matters through regulations that are not yet available. The implications of the Bill will only become fully clear once some interpretations by the Courts of a whole range of issues start to emerge – at present one has to largely speculate on how the judiciary will deal will these matters as no case law exists.

The lack of detailed information places the industry at a severe disadvantage, as the actual assessment and quantification of the impact of the Bill cannot be done in the absence of knowing the regulations.

This comment therefore by necessity argues the case in principle, at a theoretical policy level. It also relies on preliminary assumptions regarding the likely judicial interpretation and treatment of a range of new concepts that are encoded in the draft statute and for which case law does not exist.

**1. The three key policy pillars of the Bill**

The Bill introduces three key policy interventions in the credit market with significant combined potential impact:

**a. Reckless lending**

i. The intervention on reckless lending makes the extension of credit to an individual unable to afford the credit, an offence. The intervention appears to be based on a view that there are significant numbers of providers that are willing to recklessly extend such credit despite the risk of default and losses inherent in such a practice. The extent of this alleged phenomenon was not quantitatively established by the law makers and an analysis of the national bureau data indicate that, to the extent present, such activities at most affect a minority of credit active consumers in the economy.

ii. In an attempt to eradicate this alleged practice the lawmakers impose in the Bill, onerous obligations on all credit providers to assess the affordability of credit before granting it, and impose very severe penalties on providers found guilty of the offence, including subordination and suspension of finance charges or even forfeiture of any claims for repayment of the debt.

iii. It would be reasonable to conclude that this policy intervention (a world first) introduces a significant and pervasive new risk in the market for credit providers, as claims of recklessness by definition will be made ex post facto, challenging potentially large numbers of loans made, if the methodology/ parameters systematically applied by the provider are challenged.

iv. Credit providers (especially large/ formal and regulated enterprises) will have to err on the side of caution. They will have to create audit trails of credit assessments, relying on formal evidence of affordability and evidence of total credit exposures in support of granting decisions, in order to enable them to put forward effective legal defence in the event of challenges by consumers/ debt councillors. Not being able to prove, when challenged, that such an assessment was done, later results in an automatic assumption that the credit was reckless in terms of the Bill, irrespective of whether the borrower was overextended by the credit or not.

v. Reliance on behavioural scoring mechanisms alone (in high volume/ low value unsecured retail credit environments) will not satisfy this requirement. The cost and inconvenience of full physical assessments with documentary support will become part of every transaction for providers and consumers alike (irrespective of size of transaction or the credit standing/ history of the borrower). This is likely to impede progress towards increased efficiencies/ lower transaction costs through the use of technology, electronic transacting and automation.

vi. Systemically these provisions are likely to make credit providers cautious of borrowers who may be more prone to financial distress and therefore have a higher propensity to resort to this new defence in law. The cost and effort required in complying with these provisions and defending such actions by consumers clearly become economically more justifiable as the size and profitability of transactions increase.

vii. The impact of this policy intervention is therefore likely to drive credit allocation in the market to larger value transactions in the more affluent higher net worth (super- included) consumer segments, with a concomitant potential reduction in credit provider risk appetite in the lower (more marginal) income, poorer and higher risk segments of the market who are presently marginally included on the fringe and formally excluded from access.

viii. This effect could be mitigated if providers of credit are allowed to price credit at a level that allows them to recover the additional costs of administration and added potential risks the legislation will impose. The final effect of these provisions will only be determinable once the regulations on the limitations on fees and interest are available.

**b. Debt mediation and counselling**

i. Consumers gain the right under the Bill to pre-empt legal enforcement of credit agreements by opting for a debt counselling/ mediation process (again a first in the world) which could further delay/frustrate proceedings through various new defences and procedures in the Bill. During such processes the rights of all creditors to enforce credit agreements are de facto suspended.

ii. Although the Bill imposes time limits on the debt counselling and other processes, it allows for the courts to re-instate the review process following a challenge by the provider after the initial 60 day period (at the sole discretion of the court) with no limitation on the number of times this process can be repeated.

iii. The consumer can obtain a further up-to-60-business-days payment holiday by simply disputing an entry on a statement of account, which under the Bill has the effect of suspending the rights of the provider to take steps to legally enforce the contract until a prescribed dispute resolution process with a minimum prescribed 40-business-day period is completed.

iv. Although these provisions are aimed at providing a soft landing for over-extended borrowers who have been recklessly lent to or borrowers with legitimate disputes on the veracity of statements of account, the processes are available to all. The provisions can therefore potentially be abused as there are no penalties to prevent consumers who merely wish to abuse the system, even repeatedly, from doing so. Where they have successfully used the process and then paid their debts under restructured arrangements, the history has to be expunged. It cannot be used to influence future granting decisions even though further lending to such a borrower could be considered reckless.

v. The Bill also leaves the choice open to a consumer to pursue the route of an administration order under Section 74 of the Magistrates Court Act, after having concluded the debt mediation route and again defaulted.

vi. The counselling/mediation process no doubt has a lot of merit but, given that the process is being statutorily entrenched and in the absence of any sanction for abuse by consumers, it is likely to introduce new and pervasive risks and additional costs in the market for credit providers.

vii. Delays and complexities in enforcing credit agreements and mounting arrears (without the ability to enforce payments) result in higher bad debt provisions and write-offs, directly impacting profitability and compelling providers to increase prices to compensate for the added risk and reduce exposure to high risk borrowers.

viii. These risks are likely to result in increased risk aversion amongst credit providers towards:

    (1) Consumers with a perceived higher propensity to experience financial distress; and

    (2) Low-value, unsecured transactions with consumers where the likely costs and risks involved exceed the potential profits to be derived.

ix. As with reckless lending, the market segments likely to be most severely impacted are expected to be low-value credit transactions with lower income/ low net worth consumers. Credit allocation in the economy would therefore be driven more to the super-included, higher net worth segments in the market, where the economic costs/ inconvenience of abusing these processes will be more likely to exceed the temporary economic benefits and where providers would be able to economically justify incurring costs to deter abuse – although abuse even in these segments would be possible.

x. This effect could however be mitigated by the ability of providers to price for the additional costs and risks implied. The final effect of these provisions will only be determinable once the regulations on the limitations on fees and interest are available.

**c. Price control/ Usury containment**

i. The Bill envisages the imposition of limits on fees and interest charges for credit transactions. In the absence of the actual proposed controls, it is impossible to assess and quantify the impact.

ii. It is Government's stated policy intent to curb usury (excesses) rather than introduce price controls (although this is not spelt out in the Bill). If this results in limits above the level where the bulk of formal market legal credit transactions presently clear in the market (including transactions under the present Usury Exemption), the impact of these regulations should be benign, provided that the structure of limitations does not introduce supply-side distortions in the market.

iii. The economic consequences of price caps on credit are:

    (1) The structure of the cap (whether it disaggregates pricing, introduces loan size steps, enforces rand denominated, rather than relative or percentage based, fee and charge limits etc., directly affects the degree of distortion of credit extension and the extent to which arbitrage opportunities arise that can be exploited by providers through the manipulation of product allocation, transaction values and repayment terms; and

    (2) The level of the cap directly affects access (or the degree of exclusion) in the market. Credit transactions will only happen where providers can recover the full costs incurred, a risk margin sufficient to cover the likely bad debt losses and a sufficient profit to yield a return on their capital sufficient to justify the risk taken in exposing that capital. Transactions with consumers will simply not happen if the permissible price is inadequate to justify the transaction.

Lower lending volumes resulting from exclusion transfer fixed costs onto the remaining borrower base and increase the upward pressure on charges.

iv. Low value, unsecured advances to risky customers generally attract the highest rates. The larger the transaction, the better the asset provided as security, and the lower the risk profile of the borrower, the lower the price.

v. The introduction of price ceilings below prevailing prices for the highest risk/ highest cost transactions in the market (cost control) will therefore result in the exclusion of high risk borrowers from legal access to credit and a concomitant shift of fixed costs to the remaining eligible consumer base in the economy. Perversely, such an intervention would therefore, at a macro level, potentially both exclude more vulnerable borrowers from access and simultaneously increase the cost of credit provision to the remaining eligible market.

vi. The introduction of a ceiling level that is above the prevailing highest prices for the most costly and risky consumer segment and transaction types, thereby containing usury but allowing the market to clear, will avoid the perverse consequence of denying credit to the poorest people, provided that the level and structure of the ceiling is not in itself distortive in nature.

2. **The likely impact of the Bill on the allocation of credit**

a. The final impact will only be possible to assess and quantify once all the regulations envisaged in the Bill are known, the most critical of these being the price ceilings. To the extent that such ceilings allow pricing for the uncertainty, costs and risks emanating from the provisions contained in the legislation and regulations, there will not be undue negative consequences for consumers.

b. However, if there are price ceilings that make lending to consumers representing the most risky and costly transactions in the market, the likely impact (at the systemic level) of the combined three policy pillars of the Bill as outlined under 2(a-c) above, the predictable response of credit providers will be:

i. **An increase in risk aversion** towards higher cost/ higher risk transaction types and consumer segments. In turn this will reduce competition, choice and access for consumers.

ii. **Avoidance/ contraction of credit extension in risky areas** affecting the (present) partially-included, fringe and excluded segments of the SA consumer market (in terms if the DTI classifications) who, in terms of the research conducted by the DTI constitutes the vast majority (by number) of credit-active and potentially credit-active adults in SA.

iii. **A reduction in the volume of credit extended** (number and value of transactions). Given that approximately 70% of costs in the industry are of a fixed nature, the reduced volume absorption base will result in an increased unit cost, which will exert upwards pressure on prices charged across the board and especially in areas where consumers have limited negotiating power, in order to maintain profitability levels.

3. **In summary**

The likely macro impact of the Bill in the credit markets of SA based on the assumptions as outlined above (in the absence of insight into the regulations) can be summarised as follows:

a. **Reduced competition and choice in the partially included, fringe and excluded consumer market segments**

The combination of reckless lending provisions, systemically increased delays, complexity and costs in resolving civil debt disputes/ enforcing credit contracts and the imposition of price controls below the maximum levels of pricing presently prevailing in the market for high risk/ high cost transactions are likely to substantially lower the propensity of providers in the credit industry as a whole to innovate, expand and take risk in higher risk segments of the market, representing the majority of presently disadvantaged potential borrowers in the economy.

b. **Re-enforcement of the dual credit economy**

Levels of exclusion from access to formal/ legal credit under this scenario is as a consequence likely to be systemically increased with a concomitant systemic escalation in illegal credit extension activities. The Bill is therefore likely to reinforce and exacerbate the dual credit market presently in existence due to the present statutory dispensation and criminalise a large component of credit extension/ borrowing presently legally accommodated under the Exemption to the Usury Act. In terms of the categories of market exclusion as outlined by Dr. Hawkins in the DTI research, the impact is expected to be as follows:

i. **The super-included** (monthly incomes above R10 500 and with fixed assets) are likely to remain super-included and largely unaffected (although slightly inconvenienced and potentially paying slightly more);
ii. **The included** (monthly incomes between R3500 and R10500 but with some fixed assets) are likely to retain access to lesser volumes of credit and will pay more, as many are likely to be driven to the very short-term end of the lending market where prices are very high due to the high relative cost of transacting;
iii. **The fringe** (with low to moderate incomes between R1500 and R3500, no fixed assets and presently restricted access largely under the Usury exemption) are likely to become more marginalised and driven to illegal access outside the effective protection of the Bill and to the extent they do retain access will pay more; and
iv. **The formally excluded** (with low/ intermittent and largely informal incomes and no fixed assets) are likely to increase considerably with the associated escalation of illegal borrowing/ lending activities at prices likely to be substantially in excess of any limitations applicable in the formal regulated market.

c. **Increased costs per unit for those who retain access**

Upward pressure on the price of credit for those who are not excluded is likely to manifest itself as lower transaction volumes force credit providers to recover costs from fewer borrowers. Lower income borrowers are likely to be worst affected by such cost escalations due to the fact that the super-included segment consumers have the negotiating power to prevent costs from devolving on them.

**Temba A. Nolutshungu**
Director

**Eustace G Davie**
Director

The Free Market Foundation of Southern Africa